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AN INTERDISCIPLINARY JOURNAL OF PUBLIC POLICY ANALYSIS

FROM PLAN TO MARKET: THE POST-SOVIET CHALLENGE
PART I

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James M. Buchanan	The Minimal Politics of Market Order *Comment by* **Boris Milner**
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George Gilder	The Law of the Microcosm and the End of Socialism

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EDITOR'S NOTE

The papers from Cato's Moscow conference—**Transition to Freedom: The New Soviet Challenge**—are being published in two parts: Part I appears in this issue; and Part II appears in volume 11, number 3. Both issues are being published simultaneously. This decision was based on the large number of papers to be published and the importance of the topic.

During the early part of September 1990, the Soviet Union found itself at a critical juncture as the Shatalin 500-Day Program was being debated. The economic and political crises were worsening and a decision had to be made about whether to move ahead with radical reform or take a more conservative path toward democracy and the market. The papers in these two issues of the *Cato Journal* provide a snapshot of the historical processes that were unfolding and an analysis of the fundamental problems that continue to plague the transition from plan to market.

Although the political landscape has changed dramatically since the September 1990 conference, the economic revolution has barely begun. The failed coup d'etat in August 1991 and the formation of the Commonwealth of Independent States in December 1991 were the final death blows to the Soviet state, but the private property foundations of a free-market system have yet to be put into place. There is no effective legal system, commercial code, or accounting system; state-owned enterprises continue to face a "soft budget constraint" and are heavily subsidized; the state monopoly of trade and industry persists; prices are not yet fully free to respond to supply and demand; there is no constraint on money creation; and the ruble remains inconvertible.

This joint issue of the *Cato Journal* addresses the question of how to make the transition from a planned economy to a private free-market system. The papers are broad in scope and go beyond purely technical economics to address the constitutional, institutional, legal, philosophical, and social problems involved. Thus, the papers have great relevance for understanding the transition process and the challenges that face the post-Soviet leaders as they try to move toward a free and civil society.

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The Cato Institute gratefully acknowledges the support of **Arthur** and **Johanna Cinader** and the **John D. and Catherine T. MacArthur Foundation,** which made it possible to hold the Moscow conference and to publish this double issue of the *Cato Journal.* Special thanks also go to J. B. Fuqua, Richard Gilder, K. Tucker Andersen, Lloyd Buchanan, Jay and Ethelmae Humphreys, Michael and Lindy Keiser, Joseph D. Stilwell, and other supporters of the conference.

The Academy of National Economy, the Academy of Sciences of the USSR, the Central Economic-Mathematical Institute, and Moscow State University cosponsored the conference. Edward D. Lozansky and his staff from the Independent University helped coordinate the event, which took place at the Uzkoye Hotel.

—J. A. Dorn

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INTRODUCTION

FROM PLAN TO MARKET: THE POST-SOVIET CHALLENGE

James A. Dorn

> It is hard—very hard—to admit that your life and your work are being senselessly wasted and that you are living in an unnatural, false society, headed with your country for the dead end of history.
>
> —Alexander Tsypko[1]

The Collapse of Communism

As early as 1920, the Austrian economist Ludwig von Mises pointed to the inherent difficulties of communism and predicted that rational economic calculation would be impossible without private ownership of the means of production and money prices.[2] In his great work *Socialism: An Economic and Sociological Analysis* (1922), he presented a devastating critique of socialism as it affected not only economic life but also social order and human freedom.

In his work, Mises demonstrated that without private property, there could be no real competitive markets and no prices to guide rational economic calculation. As such, the centrally planned, socialist economy was bound to fail in its attempt to duplicate the efficiency and wealth creation of a private free-market system. He further showed that in a world of change, an economy devoid of private property rights would result in the politicization of economic decisions; hence, the loss of property implies the loss of freedom.

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[1]Remarks at the Cato Institute's conference "Transition to Freedom: The New Soviet Challenge," Moscow, September 10–14, 1990; in Tsypko (1991, p. 286).

[2]At about the same time Mises (1920) introduced his critique of socialism, two others offered similar critiques: Boris Brutzkus (1921) in Russia and Max Weber (1921) in Germany. For a discussion of Mises, Brutzkus, and Weber, see Hayek ([1935] 1975, pp. 32–35).

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Friedrich A. Hayek, following in Mises's footsteps, brought his keen insight to bear on the problem of the use of knowledge under socialism. A fundamental flaw of central planning, according to Hayek (1945), is that unlike competitive markets it offers no way to discover and process localized information. The more rigid prices become, the less useful information they convey.

Hayek also criticized the notion of "market socialism." In his view, incentives and behavior under market socialism would not be materially different from those under central planning; socialism is socialism, and pseudo-competition cannot duplicate the competitive market process (Hayek 1935, chap. 5; Hayek 1940).

Like Mises, Hayek was concerned not only with the effect of socialism on efficiency but also with its effect on freedom. In *The Road to Serfdom*, which was to become one of the most influential books of the century, Hayek explained why under socialism the worst get to the top, and why when there is no private property, there is no freedom.

On property and freedom, Hayek (1944, pp. 103–4) wrote:

> What our generation has forgotten is that the system of private property is the most important guaranty of freedom, not only for those who own property, but scarcely less for those who do not. It is only because the control of the means of production is divided among many people acting independently that nobody has complete power over us, that we as individuals can decide what to do with ourselves. If all the means of production were vested in a single hand, whether it be nominally that of "society" as a whole or that of a dictator, whoever exercises this control has complete power over us.

And on the politicization of life under socialism, Hayek (1944, p. 107) wrote:

> As soon as the state takes upon itself the task of planning the whole economic life, the problem of the due station of the different individuals and groups must indeed inevitably become the central political problem. As the coercive power of the state will alone decide who is to have what, the only power worth having will be a share in the exercise of this directing power. There will be no economic or social questions that would not be political questions in the sense that their solution will depend exclusively on who wields the coercive power, on whose are the views that will prevail on all occasions.

The close link between politics and economics under socialism means that any failure of the economic system (central planning) implies a failure of the political system (communism). Thus, chang-

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ing the economic system under socialism requires changing the political system as well.

Mikhail Gorbachev recognized this point when he took over as head of the Soviet Communist party in 1985. He was by no means committed to radical economic reform—that is, to the creation of a private free-market system—for he knew such a change would mean the end of communism and his political power. What he wanted was the market *plus* socialism—an irreconcilable position. That is why his policy of perestroika (or economic restructuring) failed. Nevertheless, his policy of glasnost (political openness) helped crack the Communist state and laid the basis for more radical economic reform.

By 1985, the Communist party had already lost its legitimacy; glasnost simply accelerated the process of decay. When Gorbachev opened the Soviet Union to the West, he allowed people to see for themselves the vast gulf between a planned and a free society. This visibility and the increase of freedom encouraged debate, which, in turn, set the stage for an intellectual revolution in the Soviet Union as well as in East Bloc countries.

Liberalization in East and Central Europe

On December 7, 1988, Gorbachev sent a strong signal to those in East and Central Europe who were contemplating radical reform. In a speech to the United Nations, he promised that the Soviets would withdraw their weapons from East Germany, Hungary, and Czechoslovakia by 1991. This decision, plus the expectation that Russian forces would not intervene militarily, gave reformers the confidence to proceed with their plans for liberalization. By 1989, the "market liberal revolution" had begun.[3]

Once the door was open for political and economic liberalization in East and Central Europe, the process spread rapidly. The ossified and artificial structure of the postwar Communist states could not stand the forces of change and the demand for freedom. Some of the key political events that marked the liberalization process during 1989 and 1990 are summarized in Table 1.

The revolution in East and Central Europe reverberated back to the Soviet Union, which itself was an artificial creation and ready to fall.

Death of the Soviet State

The Soviet state faced a mounting economic and political crisis in 1989. Perestroika had not increased economic growth as promised

[3]This term seems appropriate since the radicals wanted to move toward a free society and a market economy.

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TABLE 1

LIBERALIZATION IN EAST BLOC COUNTRIES

Date	Political Measures
April 17, 1989	Solidarity gains legal status in Poland.
July 6, 1989	Gorbachev promises not to interfere with liberalization in Hungary and Poland.[a]
September 11, 1989	East Germans allowed to exit through Hungary.
October 6–7, 1989	The Communist party is abolished in Hungary. Gorbachev visits East Germany and urges reform.
October 23, 1989	Hungary declares itself an independent democratic republic.
November 9, 1989	The Berlin Wall opens.
November 29, 1989	Czechoslovakia's parliament abolishes the Communist party's constitutional monopoly on power.
December 1, 1989	East Germany follows suit.
December 13, 1989	Bulgaria does the same.
December 25, 1989	Romania's provisional government is recognized by the United States and the Soviet Union.
January 27–28, 1990	Poland's Communist party dissolves itself and forms a Social Democratic party.
May 27, 1990	The first free elections since World War II are held in Poland.
October 3, 1990	East and West Germany are reunified.
December 9, 1990	Lech Walesa is elected president of Poland.

[a] Gorbachev, no doubt, was influenced by the Tiananmen Square massacre (June 4, 1989).

(there had been virtually no privatization or liberalization), and the Communist party retained its constitutionally guaranteed monopoly on political power. Reformers understood that little progress could be made on economic restructuring until the political regime was changed. The success of the democracy movement in the East

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encouraged democratic forces in Russia and other republics to push for political reform, and glasnost allowed them to do so.

A major step came in March 1989, with the first multi-candidate parliamentary election since 1917. The Congress of People's Deputies was instituted and, in May, Gorbachev was appointed president of the Soviet Union, although he still retained his title as head of the Communist party. In July 1989, Boris N. Yeltsin, Andrei Sakharov, and other deputies formed the Inter-Regional Group of People's Deputies, which favored radical reform and human rights.

The real political changes, however, began to occur in 1990 with the repeal of the Communist party's monopoly on power and culminated in 1991 with the popular election of Boris Yeltsin, the failed August coup d'etat, the formation of the Commonwealth of Independent States (CIS), the resignation of Gorbachev, and the formal end of the USSR on December 31. Table 2 presents a summary of those and other key political events during the 1990–91 upheaval and death of the Soviet state.

When Stanislav Shushkevich, Boris Yeltsin, and Leonid Kravchuk met on December 8, 1991, to declare the formation of the Commonwealth of Independent States, they concluded:

> The shortsighted policy of the center has led to a deep political and economic crisis, to disintegration of the economy and catastrophic decline of the living conditions of practically all the sectors of the population.[4]

With the collapse of communism and the end of the Soviet state, the leaders of Belarus, Russia, and Ukraine set out to create a new political/constitutional order—one based on individual sovereignty and the rule of law. The leaders were also committed "to carry out coordinated radical economic reforms aimed at creating feasible market mechanisms, transformation of property and ensuring the freedom of entrepreneurship" ("Text of Declarations" 1991). Thus, the path was now clear for the transition from a planned to a market economy.

Transition from Plan to Market

As the Soviet state began to crumble, so did central planning; but private markets were slow to appear. Vested interests blocked attempts to liberalize the economic system and sought to protect their privileges. By the summer of 1990, the Soviet economy was in a precarious situation. Gorbachev and his government, headed by

[4]Cited in "Text of Declarations" (1991).

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TABLE 2

DISINTEGRATION OF THE SOVIET UNION

Date	Political Measures
March 15, 1990	Congress of People's Deputies repeals the Communist party's constitutional monopoly on power.
July 2–12, 1990	Boris Yeltsin, Anatoly Sobchak, and Gavriil Popov resign from the Communist party.
June 12, 1991	Yeltsin elected president of Russia by popular vote.
August 19–21, 1991	Hard-liners stage coup d'etat one day before Union treaty is to be signed; coup fails.
September 6, 1991	Soviet parliament transfers power to republics and creates a transitional government; a "Union of Sovereign States" is proposed.
November 25, 1991	Gorbachev and the leaders of seven republics fail to agree on Union treaty.
December 1, 1991	Ukraine declares independence.
December 8, 1991	Byelorussia (Byelarus), Russia, and Ukraine form the Commonwealth of Independent States (CIS).
December 17, 1991	Gorbachev announces his agreement to let the USSR formally end on December 31.
December 22, 1991	Leaders of 11 former Soviet republics meet in Alma-Ata and support the CIS.
December 25, 1991	President Gorbachev resigns.
December 31, 1991	The USSR ceases to exist.

Prime Minister Nikolai Ryzhkov, faced a critical test: to take a rigid, failing socialist economy and transform it into a modern market economy.

When Gorbachev took over as leader of the Communist party, he was well aware of earlier attempts at economic reform—attempts that were doomed to fail because they were implemented within the existing power structure and did nothing to change the ownership structure. Glasnost helped break the ice for political reform, but in

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1990 conservative forces were still strong. Gorbachev himself spoke about the benefits of a market system, but what he had in mind for the Soviet Union was a regulated socialist market not a free private market.[5]

As the economic crisis deepened, Gorbachev decided to take a chance and consider thoroughgoing reform. Thus, on July 27, 1990, he met at the Kremlin with his economic adviser and cabinet member Stanislav Shatalin. During that meeting, Shatalin asked Gorbachev: "Is this just another matter of 'improving socialism' or creating a 'controlled market?' Because if it is, I'm a sick man and I don't have time left for such follies" (Remnick 1990a, p. A1).

Shatalin received Gorbachev's assurance that he was serious about radical economic reform. A working group was then formed by a joint decision of Gorbachev and Yeltsin. Shatalin, who headed the group, was instructed to prepare a program for the transition to a free-market system. In August, the working group issued a report, *Transition to the Market* (Shatalin et al. 1990), which was based on the "400-Day Project" that Grigory Yavlinsky had prepared earlier as an adviser to Yeltsin. The Shatalin report came to be known as the "500-Day Plan" or "500-Day Program," since it set out a 500-day timetable for making the transition to a market economy.

The Shatalin 500-Day Program

The report released by the Shatalin group consisted of two parts: Part 1 dealt with "The Concept and Program" and Part 2 consisted of the "Draft of Legal Acts." The entire document ran to about 400 pages. It was an impressive blueprint for the transition process.

The program set forth principles for a "new economic system," proposed an outline for an "Economic Union of Sovereign Republics," and provided a series of measures that would convert the state-directed economy into a market-directed economy in less than two years.

In the introduction to the report, entitled "Man, Freedom, and Market," the Shatalin group presented its market-liberal vision (Shatalin et al. 1990, pp. i–ii):

> The program sets forth the task of taking everything possible from the state and giving it over to the people. . . .
>
> Nobody seeks to impose anything on anybody. Everybody has a right to choose, guided by his own wishes and capabilities, whether

[5]Milton Friedman (1990, p. 5) uses the expression "free private market," and points out that "the words 'free' and 'private' are even more important than the word 'market.' " He advises reformers to make "the widest possible use not of the market but of 'free private markets.' "

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> to become an entrepreneur, an employee of the state apparatus or a manager at a stock company, to engage in individual labor, or to become a member of a co-op. The reform grants citizens the right to economic self-determination, setting the rules which will prevent certain people, groups of people, enterprises and regions from infringing upon the economic rights of others while pursuing their own interests. It is freedom of choice which makes the basis for personal freedom of the people, for the realization of the creative potential of a personality. These are not yet rules for the future market economy, which will emerge only in the course of the formation and development of a market-oriented society. The economic thrust of the suggested program is the transition to the market, laying the groundwork for a society based upon new economic principles.

It is important to recognize that the Shatalin report did not envision the creation of a market economy within 500 days. Rather, the goal was to begin creating the institutions necessary for a free socioeconomic system and then let the system evolve naturally. Shatalin and his team took a comprehensive approach to the transition problem; they rejected both the gradualist, piecemeal approach and the "Big Bang" approach.

The primary goal of the 500-Day Program was "to achieve economic freedom for people and build an efficient business system on this base" (Shatalin et al. 1990, pt. 1, p. 7). In the view of the framers of the report, the only way to achieve freedom and prosperity was through the adoption of the institutions of a free private market (pt. 1, p. 7):

> Mankind has not managed to create anything more efficient than a market economy. It gives strong incentives to materialize a man's abilities, to activate labor and business, and to expedite greatly the progress of science and technology. Its own self-adjustment and self-regulation gears take care of the best possible coordination of activities of all economic subjects, rational use of labor, material and financial resources, and balance the national economy. Obviously, transition to an economic system based on market relations is the only way to solve the country's most acute problems, to develop natural links between our economy and that of the world, to ensure production growth according to people's needs and thus the economy's social orientation, to eliminate shortages, and to make the achievements of world civilization accessible to our people.

The Shatalin program set out the prerequisites for a market economy in the form of the following eight "principles of the new economic system" (pt. 1, pp. 7–9):

> 1. The maximum freedom for economic subjects (an enterprise or an entrepreneur). . . .

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> 2. Full responsibility of an economic subject for the results of the business, based on legal recognition of all kinds of property, including private property. . . .
>
> 3. Competition of producers as a major source of incentives to business activities, improvement in the variety and quality of goods to meet market requirements, cost reduction and price stabilization. . . .
>
> 4. Market [determined] prices. . . .
>
> 5. Market relations should be extended to all spheres that are more efficient than state or other forms of regulations. . . .
>
> 6. The economy of the USSR should be open and consistently integrated into the world economic system. . . .
>
> 7. A major responsibility of state authorities at all levels, primarily at Republican and local ones, is to provide a high standard of social security of the people, which is to be understood, on the one hand, as a guarantee of equal opportunities for all people to earn their own living, and on the other hand, as state support to disabled or socially vulnerable people. . . .
>
> 8. All government bodies relinquish their direct engagement in business (with the exception of some special fields).

Part 1, chapter 3, of the report dealt with the formation of an "Economic Union of Sovereign Republics," which had the broad support of republican leaders. The report set out the rules for a new economic constitution that would result in a loose confederation of sovereign states, in which the central (Union) government would have only a few well-defined powers. A free-trade area would be created, private property rights would be protected, and the taxing and spending powers of the Union government would be strictly limited. Indeed, the Union government would have no power to tax; its revenues would be dependent on republican governments and the people.

The Union government also would lose its power to print money to finance deficits. A Union Reserve System was to be created to supply a common currency and to conduct All-Union monetary policy aimed at achieving price stability during the transition process. The new central banking system was to be patterned after the Federal Reserve System but without the tool of open-market operations (see Shatalin et al. 1990, pt.1, pp. 25, 57–61).

Thus, the Shatalin program would radically alter the existing political, social, and economic structure of the USSR, and thereby radically alter the power structure. As such, the program was a direct threat to the Communist party leadership and to the nomenklatura. That is why Shatalin, Yavlinksy, Petrakov, and other members of the task

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force sought to move quickly to introduce legislation and to get the transition process under way by October 1, 1990.

The Shatalin report lays out in some detail the various actions to be taken during the first 100 days, the 100th to 250th days, the 250th to 400th days, and the 400th to 500th days (pt. 1, pp. 22–36). There is no need to repeat those details, except to point out that the expectation was that economic stabilization, privatization, marketization, demonopolization, and price liberalization could all be started (but not necessarily completed) within 500 days. The institutional framework would then be set for the "new economic system."

Boris Yeltsin was quick to latch onto the 500-Day Program; he released the Shatalin report on September 3, and the Russian Parliament adopted the program on September 11. Gorbachev accepted the report in principle but still bent an ear to his conservative Prime Minister Ryzhkov, who on September 11 openly criticized the Shatalin 500-Day Program in the Congress of People's Deputies. What Ryzhkov wanted was a "regulated market economy" with a strong role for the center.

The stage was set for intellectual warfare, and it was witnessed at the Cato Institute's conference, "Transition to Freedom: The New Soviet Challenge," held at the Academy of Sciences' Uzkoye Hotel. With a packed conference hall, Moscow City Council Chairman Gavriil Popov, a supporter of the 500-Day Program and a People's Deputy, told his audience, which included leading market liberals from the West, radicals from the various Soviet republics, and conservative hard-liners:

> There have been dramatic changes today [September 11, 1990]. The old forces are threatening the new program. We may have to ask the people to go into the streets. We have just entered the most dramatic period in our process.[6]

Gorbachev had to make a choice: to follow in Yeltsin's footsteps or to waver on his promise to Shatalin and move toward the conservative agenda. On September 13, he decided to go with the Shatalin Plan; he criticized Ryzhkov and presented the 500-Day Program to the Supreme Soviet. But Gorbachev continued to be pressured by the conservative camp, and the war was far from over.

The Supreme Soviet made two critical decisions on September 24: It gave President Gorbachev emergency powers to bring about economic reform, and it delayed adopting the 500-Day Program. The delay of radical reform by the Soviet government came at a time when Russia was already committed to the Shatalin Plan. But without

[6]Cited in Asman (1990).

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the full support of the Supreme Soviet, the Russian parliament would have great difficulty implementing the program. Moreover, the West would remain skeptical about the chances for real reform. The Bush administration choose to wait and see, rather than to encourage Russia to go it alone or to encourage Gorbachev to adopt the radical 500-Day Program (Barber 1990, p. 1).[7]

By failing to give moral support to those who favored comprehensive reform, the Bush administration unwittingly aided the Soviet hard-liners who were pressuring Gorbachev to protect his power center by rejecting the radical decentralization of economic and political life that would occur if the Shatalin program were implemented. In the end, Gorbachev reneged on his commitment to Shatalin and decided to promote a compromise plan drafted by economist Abel Aganbegyan.

The Basic Guidelines: A Compromise Program

On October 16, 1990, the Supreme Soviet adopted the compromise program under the label "Basic Guidelines for Stabilization of the Economy and Transition to a Market Economy." The guidelines provided for economic stabilization, privatization, price liberalization, and other measures that were part of the Shatalin Plan.[8] However, unlike the Shatalin Plan, the guidelines took a piecemeal approach to reform, had no timetable, and left the division of economic power between the center and the republics uncertain. As Niskanen (1990, p. 9) stated, "The Gorbachev [compromise] plan does not address the constitutional relations between the republics and the Union government, suggesting only that economic policy would be developed by 'an interrepublican economic committee.' " The conservative lining here was evident.

The gradualist and timid approach taken by the guidelines did little to reassure the Shatalin camp that sound steps were being taken to establish freedom and democracy. Indeed, government spending continued unabated as did the growth of the money supply. Thus, on November 4, 1990, the Shatalin group, in an open letter to the press, criticized both the Union government and the Russian government for failing to curb spending and for endangering society with the specter of hyperinflation. Under such conditions, they argued, the 500-Day Program was doomed to fail (Peel 1990, p. 1).

[7]The Bush administration made no attempt to offer even moral support for the Shatalin Plan, which would have undermined Gorbachev's power. As Lionel Barber of the *Financial Times* noted from Washington in September 1990, "The administration has little stomach for speaking out in favour of the Shatalin plan" (Barber 1990, p. 1).

[8]For a discussion of the guidelines, see Bredenkamp (1991, p. 20).

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Gorbachev further undermined his credibility with radical reformers when he selected Gennady Yanayev as his vice president on December 26. Yanayev, a hard-liner, told the Congress of People's Deputies, "I am a Communist to the depths of my soul" (Remnick 1990b, p. A1).

On January 22, 1991, Shatalin published a letter to President Gorbachev in *Komsomolskaya Pravda* calling for him to quit the Communist party and let it collapse. Shatalin told Gorbachev he should abandon the idea of a Union treaty and instead adopt the radical version of the 500-Day Program, which would establish an Economic Union of Sovereign States. A "multi-national, multi-party, multi-class government of people's confidence" should be formed to implement the reform program, wrote Shatalin. He warned that "economic catastrophe is swiftly approaching" and that Gorbachev should "resign immediately" as president if he wished to compromise (Peel 1991, p. 14).

The Grand Bargain

From the fall of 1989 to the beginning of May 1991, the Soviet government had introduced a total of five economic reform programs, none of which were fully implemented. As the economy continued to slide, a sixth plan was introduced: Prime Minister Valentin Pavlov's "Anti-Crisis Plan," which would retain central control over much of industry while gradually introducing a market economy. The Pavlov Plan allowed for some privatization but was modest compared to the Shatalin Plan. Moreover, Pavlov's program was inconsistent with Gorbachev's April 1991 agreement to pursue a policy of economic decentralization. Thus, the Anti-Crisis Plan was unlikely to prevail. For that reason, Gorbachev began to consider alternatives, one of which was a reform-for-aid program—the so-called Grand Bargain—being prepared by Grigory Yavlinsky (Gumbel 1991; Gumbel and Tucker 1991).

Unlike the radical 500-Day Plan, which Yavlinsky had coauthored, his new program linked each stage of the transition process to specific types of Western assistance. He teamed up with advisers from Harvard and MIT to form a "Joint Working Group on Western Cooperation in the Soviet Transformation to Democracy and the Market Economy." This group included Harvard professors Graham Allison, Robert Blackwell, and Jeffrey Sachs, and MIT professor Stanley Fischer (Yavlinsky and Allison were co-chairmen of the group).

On July 19, 1991, Allison and Yavlinsky outlined the working group's transition plan in a paper presented to the Senate Foreign Relations Committee entitled "Window of Opportunity: Transform-

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ing the Soviet Union into a Democracy with a Market Economy." The premise of their paper was that "substantial Western cooperation, including financial assistance, is almost certainly a necessary condition for success in transforming the Soviet Union into a market economy" (Allison and Yavlinsky 1991, p. 6). Table 1 of their paper presented the various stages of reform and specified the types of external assistance at each stage. The levels of assistance would fall as the Soviet Union approached a market economy, a process that was expected to take about seven years.

Allison and Yavlinsky's paper did not include any dollar figures for aid, but their reform-for-aid package was estimated to cost anywhere from $15 billion to $30 billion per year for the first three or four years of the program; estimates for the entire seven-year program ranged from $60 billion to as much as $250 billion. Assistance would include technical as well as humanitarian and financial aid. It was hoped that the program could begin in June 1991 and be completed by the end of 1997.

Privatization, price liberalization, and stabilization were central to Yavlinsky's new program, but the reform process was more drawn out than the original 500-Day Program. Moreover, the new program was to be driven by Western aid. The 500-Day Plan, in contrast, had made no presumption that aid was either necessary or sufficient for transforming the Soviet Union into a free and prosperous nation. Thus, the new program turned attention from the East to the West.

In general, the Western industrialized countries were not interested in bargaining with the Soviet Union. Most countries were willing to extend humanitarian support, but few were willing to commit to large-scale financial assistance—at least until they could be sure that the Soviets were serious about reform. Nevertheless, the Group of Seven (G–7) invited Gorbachev to discuss his plans for reform at the London summit meeting in July. Gorbachev was expected to follow Yavlinsky's reform-for-aid strategy but instead presented an updated version of Pavlov's Anti-Crisis Plan, which only reinforced the impression that Gorbachev was still not serious about moving to a private free-market system (Norman et al. 1991, p. 1).

The reform-for-aid strategy was predicated on the continued existence of a Soviet state. When the Soviet Union disintegrated in late 1991, the Grand Bargain died along with the Union. The responsibility for radical reform will now rest with the leaders of the newly independent states. Whether they are successful in making the transition to a viable market system, however, will depend on whether they can remove the remaining obstacles to reform.

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Roadblocks to Reform

If the ex-Communist countries of the CIS are to make the transition from plan to market, they will have to remove the barriers that still block the road to freedom and prosperity. Four major obstacles to reform continue to plague the post-Soviet landscape: (1) the rule of special interests, (2) the anti-capitalist mentality, (3) the credibility problem, and (4) the market-socialist syndrome.

Rule of Special Interests

In the absence of a rule of law, the rule of special interests has full play in the post-Soviet system. Communism may be dead, but the nomenklatura is still alive. The ruling elite under communism—managers of state-owned enterprises, directors of state and collective farms, key government bureaucrats, and military commanders—continue to exercise considerable power and have a strong incentive to protect their privileged positions. Thus, the effort to privatize state property in industry, trade, and agriculture has been at a standstill.

The Russian parliament, for example, is strongly influenced by socialists who are opposed to radical economic reform. Those in power know that once state property is abolished, they will lose their control over economic life.

The food crisis is a good illustration of the power of special interests. Small private plots, although only a tiny fraction of total agricultural land, produce the bulk of staples for the Russian family. However, instead of taking the logical step and privatizing agriculture, the Russians have delayed that measure and continue to struggle with food shortages. The roadblock to reform is the power of the agrarian special interest group, namely, the chairmen of state and collective farms who "are so opposed to private competition they have frequently ruined private initiative on their own farms rather than see their influence diminish" ("Half a Russian Loaf" 1990, p. 58).

If former Soviet republics are to end the rule of special interests and move toward a private free-market economy, it will be necessary to depoliticize economic life by establishing a rule of law. Before that can be done, however, there must be a change in the anti-capitalist mentality that has been ingrained in Soviet culture over the past three-quarters of a century under Communist rule.

Anti-Capitalist Mentality

Perhaps the biggest roadblock to developing a private free-market system is the anti-capitalist mentality that still persists in the CIS. After living off the state for their entire lives, most people in the CIS

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have become conditioned to socialism and fear the risks of capitalism. The "parasitic mentality," as Anatoly Sobchak (1991, p. 199) calls it, cannot be changed overnight. People have to acquire a market mentality and recognize the function of private property, the role of prices and profits, the importance of speculators and entrepreneurs, and the significance of spontaneous order.

If real reform is to occur, the leveling instinct must give way to the profit motive, bounded by competitive market forces and the rule of law. Unless people are allowed to keep the fruits of their labor and reap the rewards (as well as bear the costs) of their decisions over the use of scarce resources, there can be no real private markets to allocate resources and increase human welfare.

As long as envy is allowed to dictate social and economic policy, the post-Soviet Union will be unable to create the private property foundation necessary for a competitive price system. Accordingly, Otto Latsis (1991, p. 267) writes, "Widespread egalitarian notions that regard high earnings as immoral are the biggest obstacle in our way to a market economy."

Democracy, if unconstrained, could turn the post-Soviet Union into a giant welfare state. The precondition for the development of market institutions, it seems, is a widespread acceptance of the fundamental ethical principle that underlies a free-market system, namely, the sanctity of one's property rights. People have to learn the moral—as well as economic—value of respect for private property rights.

When people learn to respect the rights to life, liberty, and property, a spontaneous market order can emerge. The process of coordination will then take place according to the voluntary choices of sovereign individuals rather than through the coercive force of the state bureaucracy. The emphasis should be on whether the market process is free, not on whether the outcome of that process is socially optimal as judged by some political *apparatchik*.

The choice that the new parliaments in the CIS must make is whether to set the framework for freedom by establishing a rule of law and private property or whether to revert to the old ways and engage in "legal plunder" by passing laws that redistribute income and keep inefficient enterprises alive to satisfy special interests.

Real reform will require a psychological revolution that overturns the myths of socialism and that focuses on the reality of capitalism and the benefits of limited government. The task of reformers is to set both a legal and intellectual framework for reform.

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Credibility Problem

Another barrier to liberalization is the near universal lack of confidence in government. For years Soviet leaders have initiated reform measures only to reverse them at a later date. Economic reform has been a ragged process at best, and the lack of any *credible* precommitment to private property and free markets has increased uncertainty about the direction of future reform.

If the new governments of the CIS are to lead the way toward a real market economy, they will need to establish their credibility at the start. Stop-and-go measures will serve only to undermine public confidence and bolster opposition to radical reform. What is needed is constitutional change to override the special interests and to counter the parasitic mentality that now govern social and economic life.

Ruling by decree is no substitute for ruling by law under a freely chosen constitution that protects individual rights. Without legitimate constitutional law and an independent judiciary, the ex-Soviet Union will be subject to the discretion of rulers who may or may not support free enterprise. The resulting uncertainty will discourage domestic and foreign investment and slow the pace of reform.

Market-Socialist Syndrome

A common danger facing ex-Communist countries trying to make the transition to a market system is the illusion that it is possible to have a real market economy without establishing private property rights. Gorbachev, for example, continued to think that socialism and the market were compatible—even after the August 1991 coup.

The failure of perestroika is due to the failure to fully embrace a private free-market system. The newly emerging social democrats argue not for free enterprise but for regulated markets. Social democracy and market socialism—not market liberalism—are at the top of the agenda for many so-called reformers. As Larisa Piyasheva (1991, p. 3) writes, "The illness that infects our entire society today is social democratism, brewed on the idea of social reform in the context of a mixed economy and a 'third way.' This, in my view, lies at the root of the inadequacy of all the government and non-government reform programs."

What the CIS leaders should remember is that when the state is used to redistribute income, the very market process that creates that income will be upset. Attempts to "plan the market" by altering market outcomes can only lead to a deterioration of the incentives that drive the competitive market process and reduce the size of the economic pie. Compromising market principles for the sake of

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"social justice" can only hamper the creation of a free society and undermine the true sense of justice, namely, the protection of private rights (Hayek 1976).

A change of vision from that of market socialism to that of market liberalism requires a growth of confidence in freedom and spontaneous order. The challenge is to cultivate freedom and to recognize that the best guarantor of human dignity and prosperity is equality of freedom, not equality of outcome.

The Challenge of Freedom

Prior to the breakup of the Soviet Union, the head of the anti-Communist bloc in the Ukrainian parliament, Igor Yukhnovsky, declared: "When something is ruled from the center, the optimization of life is impossible" (Greenhouse 1990, p. A10). With the fall of the Soviet state and the collapse of communism, new life has been pumped into the drive for economic liberalization. Whether the liberalization succeeds, however, will depend on breaking the psychological and other barriers that still block the path toward private property and individual freedom.

As long as there is no constitutional reform to safeguard private property, there can be no real economic and personal freedom to establish a true market economy. As Gavriil Popov put it, "We cannot talk of freedom unless we have private property."[9] The challenge is to remove the remaining barriers to freedom by adopting a constitution that will set the basis for a private free-market system and then let the market institutions evolve spontaneously in an atmosphere of liberty.

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Transition to a Market Economy

Anatoly A. Sobchak

The Soviet Union is facing a choice of which path to follow to promote economic development. Today, virtually everyone—the economists who for decades have insisted on the need for transition to a market economy, the politicians who as recently as six months ago denied the necessity and the possibility of such a transition, and the overwhelming majority of the population—seems to have arrived at the same conclusion: The transition to a market economy is inevitable, as night follows day, and is the only way to economic revitalization for this country. We have no current alternative. The strongest argument to support this conclusion is the road traveled by a number of countries in the post–World War II period: the road from dictatorship, from totalitarian states and totalitarian economies, to the market. Unique as this road may have been for each country—Spain, China, South Korea—the end result has been the same: rapid economic development and economic prosperity. That is to say, each country reached the goal toward which our country is now striving.

Conditions for a Successful Transition

There is, however, far less unanimity concerning the problem of how to make the transition to a market economy. Yet this transition question—the problem of defining the mechanism; the ways; and the forms of going from total state monopoly of ownership, production, and all economic activity to a market economy—is the most fundamental question of all. How this question is solved will determine whether we succeed or fail in accomplishing the transition, whether this transition will be possible, and in what ways it will be made.

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Yet the program proposed by the government in May 1990 was essentially not a program of transition to the market economy but a program intended to discredit the market economy. The only thing about this plan that the population clearly understood from the report of Prime Minister Nikolai I. Ryzhkov was the government's intent to raise prices—prices, moreover, on basic food staples, especially on bread. The very idea of a price increase imposed by directive is incompatible with a market economy in which prices are determined by supply and demand, that is, by agreement between producers and consumers. The government can intervene in this process only by exerting a certain kind of influence on pricing and price balances to protect the economic well-being of the majority or of certain groups; it certainly cannot fix prices from above by fiat. Indeed, such price fixing is characteristic of the economies of the administrative command system and of barracks-style socialism, not of the market economy. What is it that we are being offered today? In my view, the conditions under which I believe the transition to a market economy is possible in this country are not very clearly defined either in the program proposed by the government or, though to a lesser extent, in the program proposed by the Shatalin team (the program coordinated with the 500-Day Plan developed by the group of economists and political leaders who support Boris N. Yeltsin).

In my opinion five conditions are necessary for a successful transition to a market economy: (1) economic stabilization, (2) a market infrastructure, (3) property ownership, (4) a change in mentality, and (5) public support. Let us consider each of these in turn.

Economic Stabilization

First, a market economy must be preceded by a period of economic stabilization. In a crisis, when the economy is deteriorating drastically, it is impossible to switch at once to a market economy without first arresting the economic decline and securing a period of economic stabilization. Such economic stabilization can be secured today primarily by activating both administrative and economic levers that I would characterize as emergency mechanisms. We could go so far as to spend certain government reserves and stockpiles, including some of our gold reserve. We must also drastically curb government spending—both domestic spending and expenditures to maintain our government's offices abroad, revise our foreign aid policies, stop government spending on large-scale economic projects that do not yield immediate benefits, sell off "frozen" uncompleted units to private owners, and so forth. In other words, we are describing a comprehensive program of economic action whose content is

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fairly well known. This program is meant to secure a period of more or less certain economic stabilization for the next 12 to 18 months; it should saturate the market to the point of meeting the basic survival needs of the population. Only against the background of such relative material well-being can the transition to a market economy—the accomplishment of the essential tasks that are the goal of such a transition—become possible.

Market Infrastructure

Second, parallel to economic stabilization, we must take measures to create the market infrastructure. The Soviet economy today is extremely primitive. It is represented by huge, monopolistic state enterprises and amalgamations. But it does not have the infrastructure required for a market economy to function. What I have in mind is a labor market, a capital market, and, as a necessary condition, numerous small and midsize enterprises that will fill the gaps in the economy and create the possibility of competition among producers and, most importantly, the possibility of economic maneuvering. The recent bread and tobacco crises are a good example of a primitive economy. They occurred mainly because most of the state-run factories producing bread and tobacco products have obsolete and shabby equipment. Either most of these enterprises had to be shut down for repairs or retrofitting, or they are facing the threat of a shutdown because their equipment will break down or need preventive repairs.

Steps must be taken to prevent such crisis situations from regularly occurring. However, we must note that today these crises are also caused partly by conservative forces trying to sabotage democratic change and to subvert the work of new local governments in large cities such as Moscow, Leningrad, Sverdlovsk, and Chelyabinsk. The main problem, however, is the absence of room for economic maneuvering. Let us imagine that these same cities not only have state-run bread factories but also have an extensive network of small bakeries, which are owned by cooperatives or individuals and are capable of taking over most tasks for producing these vitally needed staples if state bread factories grind to a halt. The same arrangement goes for all other basic foodstuffs.

We need a program designed to create small and midsize enterprises that are both collectively and individually owned. Such a program could establish a network of enterprises that could compete with the state sector and, most importantly, could take over most of the work if state enterprises specializing in the same products shut down.

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Moreover, creation of a market infrastructure requires efficient transportation and well-developed information networks with adequate means of communication, which we do not currently have on a sufficient scale or on a modern level.

Among other things, the decision has already been made to open financial and commodity exchanges in Moscow and Leningrad. This, too, is a necessary element of the infrastructure without which the market cannot exist. But for exchanges to function, we need an extensive network of joint-stock companies and associations. Those organizations do not yet exist, nor do we have effective legislation on joint-stock companies. We need to return to an extensive turnover of securities. This change, however, will take time. There will have to be a period of adjustment to a market environment, which, along with the period of economic stabilization, should last a year and a half to two years. Without our going through this stage, it is naive to think that the market economy can be introduced by an order from above.

Property Ownership

Third, the transition to a market economy requires a well-developed stratum of commodity producers who own property in different forms. To demonopolize and get the state out of the main sectors of the economy, we should create a multitiered economy primarily by privatizing trade, eateries, household services, and a major part of the state-run industry. We should also privatize agriculture as a necessary condition for providing the country with adequate food supplies. The program of privatization and the establishment of mature sectors of collective, including cooperative, ownership and of individual private ownership will take time.

As can be seen from the experience of the Moscow and Leningrad City Councils when they attempted to privatize trade and household services, such a program of privatization cannot be carried out quickly for a number of reasons. First, credit resources are needed to encourage small entrepreneurs and workers' collectives. Today, we do not command such resources. Our only hope is the establishment of investment banks, which would attract foreign investment that would allow us to secure the credits needed for privatization. Given that this process brings quick profits and that the loans would soon be repaid, this prospect is quite promising. But, again, this process will require no less than 18 months to two years. Therefore, from this angle as well, the immediate transition to a market economy, which has been proclaimed by the authors of programs now under consideration in the country's Supreme Soviet, is impossible.

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Change in Mentality

The next condition for the transition to a market economy means a profound, fundamental revolution in more than just the industrial and economic conditions of our society. What is necessary is a far-reaching change in the structure of life itself, in our way of life, in people's thinking, and in the way they see their place in the system of social production.

For decades, we have fostered a beggar mentality: The state will provide and decide everything for you—poorly, perhaps—but it will provide equally for everyone and supply all the basic necessities. This parasitic mentality is very widespread here. In contrast, a market economy, in order to function, requires a very different type of mentality: responsibility. Every person must be responsible and solve his or her own problems. The government will do nothing more than create conditions in which one can use one's own initiative and enterprise; the rest will be up to the individual. The government will maintain a social safety net for the indigent, for large families, for the disabled, and for the aged—but its interference in economic life will be limited to that. That is, government's role in economic life must be drastically reduced, or there can be no market economy. But this change requires a revolutionary transformation in the minds of people, in their psychology. Obviously, such a revolutionary transformation cannot be accomplished overnight. Any program of transition to a market economy that does not take into account this social and psychological atmosphere is doomed from the start.

Public Support

The last condition is perhaps one of the most important. A change as fundamental as the transition to a market economy can be accomplished only when it is carried out by a government that enjoys the full support and confidence of its people. Without such support, one can say in advance that any program of transition to a market economy—no matter how good it may look in theory and in the abstract—is doomed to failure.

More than once in our recent history and during perestroika, we have found that the most logically correct, theoretically well-grounded, and seemingly impeccable projects turned out to be absurd in practice and led to absurd results. Let us recall, for instance, the campaign against unearned income and the war on alcoholism; or consider what has happened to cooperatives. We know the negative consequences of all these measures, which seem based on impeccable theoretical constructs and are motivated by lofty ideals that, I would say, even have a certain romantic appeal.

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The failure of all these efforts was largely due not only to the methods or means by which they were pursued but also to the lack of necessary trust and support by the people.

Another important factor is found in the negative attitudes of government bureaucracies, particularly at mid- and lower-level, that pushed all these initiatives to an absurd extreme—deliberately in some cases or out of incompetence and ignorance in others. But today, we must be very clear as to who is going to execute all these plans. On the one hand, there must be a government trusted by the people. On the other hand, it is essential that most officials in the machinery of the state support and implement these measures. Otherwise, as before, this bureaucracy, mostly staffed by past or present functionaries of the Communist party, will be hostile toward these efforts, will try to turn them into their own opposites, will reduce them to absurdity, and will discredit them in the eyes of the public.

Creating a Legal Foundation for a Market Economy

In addition to the political, socio-psychological, and economic conditions needed for the transition to a market economy, there are also legal conditions that must be met. To create the legal foundation for the functioning of the market requires a fundamentally different approach to the legislative regulation of the economy than we have had in Soviet legislation up to now. Until now, the major share of legal norms has consisted of administrative rules, that is, direct regulation from above of all economic relations and all economic ties in the country.

It is natural that the transition to the market economy should require a fundamentally different approach, a transition to economic ties based on horizontal relations. If our economy today is dominated by vertical relations, that is, legal-administrative regulation, then tomorrow we must have relations of a civil and legal nature. These are horizontal relations, that is, economic interaction between independent economic agents—between free producers of commodities. This change requires eliminating the existing hierarchy of enterprises, so that enterprises will not be subordinate to Union, republican, or local authorities.

We must make changes in the way that enterprises are launched and closed down. If the overwhelming majority of enterprises in our country today are opened and closed by administrative decision, tomorrow it should be done on a contractual basis. That is, enterprises will be created by agreement between interested parties and will

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cease to function, once again, by agreement between the shareholders, or, in the event of incompetence, by a court decision.

In the matter of economic regulation, there should be certain changes in the relationship between Union and republican legislation. Up to now, the legislation that is currently in effect has given priority to Union laws over those of republics. However, the declarations of sovereignty passed in the Union republics have created a fundamentally new situation. If yesterday the axiom was that Union law took precedence over republican and local legislation, today declarations on the sovereignty of all Union republics are stating that Union laws are effective in a republic only when they do not contradict the republic's own legislation and only if this Union legislation is ratified by the republic—or by the appropriate body of republican government. In such conditions, there will be a natural downward shift of economic regulation, to the level of republican and municipal legislation. This shift is absolutely necessary to enable various regions and republics to show their own initiative in solving their own economic problems.

Thus a fundamentally new approach is needed when we prepare the new civil legislation. If yesterday the Basic Civil Law of the USSR, as well as a number of Union codes, dealt with questions of regulating the country's economic life, today the center of economic legislation must shift to the republican and municipal level. As an example, one can point to this process in the free enterprise or free economic zones.

In July 1990, the Supreme Soviet of Russia created a number of free economic zones in the country: Sakhalin, Leningrad, Kaliningrad, and a number of other regions. The notion of a free economic zone, as applied to the Leningrad region, is understood as giving regional authorities the necessary powers to run the local economy independently; to regulate the creation of enterprises, joint-stock companies, and new banks (including foreign ones); to attract foreign investments; to conduct foreign trade; and to handle currency, tax, and customs issues. The advantage of a free economic zone, over other regions of the country, is that it provides an opportunity to develop the mechanisms of transition to a market economy more quickly on a municipal or regional level.

The rights that will now exist in free enterprise zones, granted as exceptions to the governments of these areas, must eventually be extended to other regional governments as well. Thus, today's experiment in developing market mechanisms will become tomorrow's way of economic life on the regional level. Only this approach to free

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economic zones appears positive and realistic in the conditions of the Soviet economy.

It is important that the center of legislative regulation of economic activity in a free economic zone shift completely to the regional (or municipal) level. The appropriate authorities created by the administration of free economic zones, along with the appropriate municipal or regional bodies of government, must have the power to regulate economic activities independently. Shifting the center of legislative power (with regard to economic matters) to the republican and municipal level must also manifest itself on a number of other issues.

The transition to a market economy will require a fundamental change not only in civil and economic legislation but also in labor laws. This transition will be from a system of blind universal guarantees for any worker, even a lazy one, to a contractual system under which a worker who does his job poorly or sloppily will lose his job.

There is also a need to overhaul financial, tax, and land legislation. Virtually every law dealing to any degree with regulating economic relations must undergo significant modification. And the change must affect not only details but the most basic questions. I think the most important direction of legislative change is to purge the outdated administrative restrictions, plus the endless instructions and circulars, and to switch to a limited number of laws and sophisticated municipal legislation. These laws should comprise all necessary regulations to protect the environment and to balance the interests of producers and entrepreneurs with those of the city, the region, and the republic—that is to say, of society as a whole.

If we compare our current regional and municipal legislation with the sophisticated municipal legislation in other developed countries, the contrast—both in volume and in the legal quality of the statutes in question—is staggering.

There is yet another question of extreme importance related to the transition to a market economy. We have just taken the first step toward institutionalizing property relations. A law on property allowing for a variety of forms of ownership has been adopted. This basic legislation must be carefully developed, and more work is needed on all the secondary legal statutes that would give property owners full rights of control, possession, and use over property that belongs to them.

The legal mechanism of privatization also needs work. It is on this question that I would like to dwell. Privatization is among the most promising of the processes needed for transition to a market economy. Privatization and destatification essentially mean the creation of a multitiered economy with a variety of property owners and with

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competition, thus ensuring that the consumer can choose between producers and their goods. Today, privatization faces many obstacles. Some of these are of a legislative nature, such as restrictions imposed by law. There are also economic obstacles having to do with insufficient funds and a lack of resources for credits and loans to small entrepreneurs and workers' collectives. There are also social and psychological obstacles.

Encouraging Foreign Investment

To overcome these obstacles, we must work on legal mechanisms for attracting foreign investors and for creating joint ventures, as well as foreign-owned firms, on Soviet territory. Today, the regulation of such relations is quite complicated and is mostly left to the discretion of various administrative bodies, such as the Ministry of Finance and the Ministry of Foreign Commerce. To give this process a push, a switch to republican and local regulation is needed, along with, most importantly, removal of this legal tangle of regulations governing such contacts.

What is to be done? There are several options (given a nonconvertible ruble) to attract funds of Western investors into our economy, allowing us to ensure that they would get adequate returns.

One option is to create an investment bank or get Westerners to invest in joint-stock companies that buy back enterprises and their properties from the state. As investors channeled money into enterprises, there would be funds to rebuild and to change product lines to goods that are in demand and are competitive in domestic and foreign markets alike. This scheme would allow a faster transition of enterprises from state to collective or private ownership.

Another option is for Western investors, through Soviet banks or investment banks created with the help of investors, to give loans to small enterprises and to workers' collectives that want to set up new enterprises or buy back existing ones from the state. Investors do not acquire shares in these enterprises but rather extend loans at interest rates that would be attractive to investors and would not be prohibitive to small enterprises. Interest must be at a fairly high rate. However, making small enterprises or collectives tax-exempt for the first two years and giving them substantial tax relief in the following two or three years—which would help the private and collective sector of the economy get on its feet—would make it easier for them to pay back the interest.

A third option is also possible: The Western investor gives the necessary funds to Soviet banks or to a government body, such as a

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municipal council. The latter uses these funds to invest in privatization and repays the Western investor on a barter basis, through sales of goods manufactured by the region's enterprises, or through other means. Profits in rubles obtained by investors from joint ventures or from sales of imported goods in Soviet markets can also be invested in the tourist business. This option would allow foreign investors to receive hard-currency profits from each Western tourist who uses the hotels they have helped build or renovate—that is, to profit from international travel.

Thus, even with a nonconvertible currency, there are fairly attractive conditions for foreign businesses to invest capital in the Soviet economy. To ensure the security of these investments, it is necessary to institutionalize special legal guarantees protecting the interests of foreign investors—particularly with regard to free economic zones, where attracting foreign capital investments should be sped up as much as possible.

Conclusion

Generally, legislation in effect in the Soviet Union today already creates an adequate legal base for establishing joint ventures, joint-stock companies, and foreign investment. It does not, however, provide adequate protection for foreign investments; it makes establishing joint ventures, licensing foreign trade, and so forth a complicated process that depends primarily on administrative whim. We need a major revision of customs regulations toward more favorable conditions for foreign investors. Thus, the necessary legal conditions for successful capital investment in the Soviet economy have not yet been achieved.

To be fair, however, I must point out that an entire package of legislation has been prepared dealing with joint-stock companies, foreign investments, and entrepreneurship. These laws were designed to create a system of legal guarantees protecting the interests of foreign investors. Therefore, our conclusion should be optimistic, and the prognosis is encouraging. Only yesterday, it was extremely complicated to work with Soviet enterprises and Soviet partners, which are represented mainly by state companies or functionaries of various ministries and agencies. Yet even such contacts allowed opportunities for profit-making and successful capital investment.

We are entering a new stage when we must create and, to some extent, have already created the necessary conditions for a climate most favorable to attracting foreign investment into our economy.

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The faster we complete this process of creating the legal and economic conditions for foreign investment, the faster our economy will grow, the greater our chances of success will be, and the faster we will achieve economic prosperity.

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Perestroika and the Limits of Knowledge

Henry G. Manne

The possible introduction of economic, social, and political freedom to the Soviet Union and its people is one of the most dramatic events in modern history. To participate, even intellectually, in this process is an enormously exhilarating experience. Scholars and public affairs experts in the West have been galvanized into a near "feeding frenzy" of papers, conferences, seminars, and colloquia on this subject. Nor are the Russians themselves immune to this same excitement from travel, meetings, bold proclamations, and new friends.

As might be predicted from all this intellectual socializing, a consensus has begun to emerge as to the "proper" solution to Russia's problem. The typical Western academics who accept the prevailing ideological orthodoxy will not want to miss the boat and the chance to become "recognized experts" in the field. Therefore, it is not surprising that this emerging consensus looks a great deal like the dominant academic view of what is needed for Western Europe and the United States: well-regulated markets, a bit of socialism, and a generous welfare program.

Be that as it may, it would be extraordinarily surprising if the Russian "experts" did not jump on the same bandwagon and for some of the same reasons; after all, they like good meetings too and invitations to the "right" universities.

It is refreshing then to hear this subject addressed by someone like Mayor Sobchak, whose views are somewhat less likely to be influenced by this academic process. He is, after all, a serious player in the real political process, and he seems well informed about the more sensible academic proposals as well. Not surprisingly then, there is evidently in Mayor Sobchak's remarks a certain realism

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(or is it wistfulness?) as he proclaims the fundamental necessity of changing popular attitudes, a notion I strongly second. At the same time, however, Sobchak has proposed practical, detailed plans for action, such as his various alternative proposals for effectively financing privatization of state-owned firms. Such details coming from someone of Mayor Sobchak's experience and sophistication certainly deserve greater attention than comparable proposals coming from individuals lacking detailed experience with the Russian legal and political system.

But even from so impressive a source, detailed policy prescriptions should perforce be addressed with considerable skepticism. Some of Sobchak's remarks, for instance, may be a bit premature; he is certainly overly optimistic in assuming that changes of such profound import could be accomplished in 18 months to two years.

I propose, therefore, that for starters we all step back and attempt a more generalized, less-specific approach to Russian reform than has been popular thus far. Let us see what lessons, if any, can be learned from the long-term legal, economic, and political history of the West. This exercise may prove more effective at this juncture than any effort to emulate specific existing Western institutions where emulation is almost certain to fail.

Evolution of Economic Liberalism

In the main, the West's development of capitalist, private property, free-market institutions has been unplanned and unself-conscious. The system has evolved from historic origins little understood or recognized today. And it represents an incredibly complex intermixture of political, economic, cultural, religious, legal, and technological factors. Indeed the subject of how the system developed has been so complex that most Western, and especially American, scholars have largely despaired of even dealing methodically with it. The works of such classic figures as Locke, Smith, Hume, and other intellectual giants are little studied today in the United States. As a result, much discussion of these issues has a heavy ideological and political cast.

There are certain factors within the academy that have reinforced this tendency. The dominant Keynesian thinking from the late 1930s to the mid-1960s eclipsed the older, more philosophically oriented approaches, and the development of mathematical economics and econometrics (especially as aided by the introduction of the computer) did nothing to promote intellectual considerations of market institutions. Added to this, of course, was the heavy flirtation—in

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many cases a conjugal relationship—of many Western academics with Marxian and other socialist ideas. Ironically, however, it was during this same period that some of the most important developments in our intellectual understanding of free-market institutions occurred, and it is largely to these, as well as to some of the aforenamed classical writers, that scholars and people of practical affairs are now turning.

The Austrian School

The first of these major developments occurred in the 1930s (with recognition coming several decades later) in the work of what are now referred to as "Austrian" economists, particularly Ludwig von Mises and Friedrich von Hayek. Out of this work has come such important concepts as the subjective theory of value, the evolutionary nature of many social and legal institutions, and the impossibility of socialist calculation because of our inability to determine correct relative prices. Hayek's work is also important in the development of modern constitutional theory, a subject whose study had languished for at least two centuries.

Public Choice Theory

Closely related to this Austrian development, though with very different origins, is the modern public choice school, the first methodical, analytical tool available for explaining the behavior of political agents. While still in its infancy (or perhaps its pubescence) today, and always beset with incredibly difficult problems of empirical proof (traditional economics suffers this too, but not nearly to the same extent), public choice offers us a first insight into the relationship between private and public behavior that goes beyond mere description, rhetoric, and exhortation.

Property Rights Theory

Perhaps the most important work for our present purposes is what we now term "property rights economics," largely associated with the names of American economists Armen Alchian, Ronald Coase, Harold Demsetz, and Oliver Williamson. Early traces of this approach to economics can also be found in the major work of Ludwig von Mises. Modern property rights economics goes beyond the simple labeling of things as "public" or "private" property and instead looks at the various rights, powers, and entitlements individuals have under different legal rules. While the focus of this work has kept it within the traditional domain of economics, it has also spawned an extremely important by-product called "law and economics," or the

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economics of law. Obviously, public choice theory, constitutional theory, traditional market theory, and a variety of other notions come into play in this field as well. It remains to be seen whether law and economics will become as comprehensive in its coverage as 18th-century political economy was.

This introduction is by way of suggesting how ill-prepared we are to deal confidently with an effort to convert a Marxist-Leninist socialist economy into a private-property, free-market system. Still we are not bereft of all knowledge, and the recent scholarship is enormously relevant to the task at hand. Whether it is sufficient is another question. But it is clear that no one would have supposed 15 years ago that this contemporary American economics scholarship might eventually have a larger role in the remaking of the Soviet economy than it did in the deregulation, for example, of the American airlines. So, with considerable humility, I would like to explore a bit more deeply some of the complexities involved in the process of legal/economic development and see what we may conclude about the issue at hand.

Legal and Economic Development

One overarching difficulty needs to be established at the outset. There is no simple, magical way to achieve a complex free-market system quickly. The U.S. economy, with its attendant legal rules, has evolved over a period of at least 500 years, beginning especially with the protection of private property afforded by the English Common Law and the various relevant provisions of the U.S. Constitution, now over 200 years old. This long, largely evolutionary, and pragmatic development must be dramatically distinguished from what is being faced in the Soviet Union today. No one ever had to plan for the United States an entire system, all of whose pieces fit together in some sort of social and economic equilibrium, that had popular political support. Some of the most significant changes in the American economy over its 200 years have come about because of a complex interaction between existing laws, technological developments, and legal responses. The regulation of privately owned real property nicely illustrates this, especially since much of the Anglo-American common law had its origins in property rules.

Externalities, or third-party effects, were treated at common law mainly through the doctrine of "nuisance" or in some cases trespass. But with the development of modern cities with high population densities, traffic congestion, and pollution, this approach gradually gave way to a regime of comprehensive local and in many cases

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regional regulation. This regulation has remained economically tolerable—even if frequently undesirable and costly—for the good reason that it is so local in scope. Another way of talking about this is to point out that a lot of American regulation is, fortunately, only very weakly enforceable. Factories could simply be shifted to less costly sites, developers could build residential complexes where the regulations were less onerous, and courts do occasionally declare particularly bad regulations unconstitutional. The cumulative effect of this regulation has unquestionably been negative, but the relationship between political demands, development interests, private property ideals, constitutional limitations, and even emerging traffic patterns has by and large nestled into a relatively stable equilibrium pattern. There is at this moment no strong movement in the United States for deregulation of local zoning plans—neither is there any clamor for an expansion of the present rules.

We have, through an enormous amount of trial and error and adjustment and readjustment, reached this pragmatic position. To an innocent outsider it may look like a wonderful "system," but the truth is that this end point has no intrinsic merit or justification. It is merely the point we have reached, starting where we did with the rules and institutions we had. The process is, of course, a continuing one, so no one could reasonably advocate that the precise "logic," such as it is, of American zoning regulation should be exported to another regime. Nor is it likely to happen that completely unregulated land use can emerge in such a thick political atmosphere. It is probably impossible to guess what will be the eventual equilibrium situation in Moscow or other Soviet cities as they begin the process of adjusting to new political pressures, to some version of private ownership of land, to market transfers, and to new technology. It will not be Houston, even if it will also not be a planner's utopia. Who could be so naive as to try to predict what will ultimately emerge?

This exercise, of demonstrating the modern evolution of complex partial equilibria in various components or institutions of the American economy, could be repeated at great length in many fields and in incredibly vaster detail. But these are only piecemeal pictures. Obviously, the idea of then assembling all of these varied institutional arrangements into one relatively stable general equilibrium (for an entire nation) is a feat that not only defies our ability to perform but even our ability to describe.

That leaves us then with the annoying and frustrating question of what can we project intelligently as the most desirable program for the Soviet economy? I do not believe it is politically (or intellectually) feasible to move to a more liberal free-market system than is

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presently found anywhere in the West. Such dreaming can even be dangerous if it is not recognized as purely idealistic. But there are certain prescriptions of a general nature that can be helpful, and the more widely understood and acceptable these generalizations are, the more likely is the Soviet economy to achieve a somewhat stable equilibrium at a high level of human welfare.

A Framework for Reform

The first of my recommendations is for a massive public education program to dispel the misunderstandings and prejudices about private property, profit, freedom of contract, private enterprise, and competitive markets that are still endemic in the Soviet Union today. While ideological brainwashing by the state is generally anathema to the liberal values we in the West honor most, I believe that broader popular understanding is a necessary, though not sufficient, condition for liberalization of the economic regime. For the more popular support there is for the various institutions of a private property system, the shorter will be the period required for equilibrating all the variables involved and the less easy it will be for demagogic reaction to form.

Related to this is a second notion, perhaps as quixotic as the first and to some degree related to it. There must eventually be explicit constitutional protection for private property and freedom of contract. While constitutions must of necessity be general enough to allow flexibility in more specific lawmaking, they must at the same time put some constraint on the inevitable effort of politicians to suppress private freedom of the use and transferability of property.

Somewhat related to the idea of constitutional protection is another idea that can tremendously assist in facilitating social adjustments. I have reference to some sort of dispute resolution mechanism that has the confidence and support of the public. This clearly does not have to be precisely like the court system generally utilized in Western capitalist countries. But there must be some mechanism, ultimately with the force of the state behind it, that allows private individuals to resolve their disputes without resorting to violence.

At a minimum this is what is meant by a "rule of law." The mediating agencies need not be institutions of the state. Certainly in many commercial sectors of capitalist countries, private dispute resolution (whether arbitration or mediation) is widely used and often more respected and honored than the alternative judicial system offered by the government. But in Russia today there is no independent, nonpolitical judicial apparatus in place, and private dispute resolution

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mechanisms might take a long period to develop. Probably some combination of private adjudication with ultimate state authority to back up its decisions is the most that a rapidly emerging free-market system can hope for.

One aspect of any workable dispute resolution system that is often overlooked is that its decisions must eventually be enforceable. This implicates some use of political power, and this by itself is sufficient to explain the necessity for the development of a system of criminal law. Thus, borrowing from the American legal model, if a civil decree is not honored by one of the litigants, criminal procedures may be used to punish the recalcitrant party. Of course, criminal law is needed in a private property system for other reasons as well. Protection of private property and persons against private interferences cannot be completely ignored by the government. Thus a regime of private property probably requires that rules against theft and intentional damage be enforced by some governmental agency. But the more localized and circumscribed this authority is, the less danger there is of an abusive police authority emerging. Thus a system of government protection of private property through criminal law also implicates the strong desirability of a constitutionally restrained federalist regime (which is *not* the same as a merely *decentralized* law enforcement authority).

I am now close to a level of specificity that I opened this paper by decrying. But something must still be said about the definition, specification, and protection of private property rights. Modern property rights economics made us realize that the concept of a "property right" is best viewed not as a specific entitlement or right but rather in a generic sense as representing those particular rights or entitlements that the "owner" in fact has.

Ultimately, a thoroughgoing private property system is one that maximizes individual freedom. The two ideas are fundamentally one and the same. To the extent that "property rights" are clearly delineated and enforced, they are worth more in a market system than they would be if these matters were less clear or certain. I am not here prescribing any specific set of powers and rights that go into making what we might call "private property"; rather I am suggesting that whatever kind of private property right is allowed and protected, it will be worth more to the extent that these rules are clear and are well understood by participants in the marketplace. Thus some form of public or private title registry, or other kind of "proof" of ownership, is highly desirable. This protection is a low-cost device for making all property more valuable than it would otherwise be. One of the many inherent inefficiencies of any socialist system is the fact

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that no one recognizes or understands who really owns a large part of the goods and services. Thus cultural attitudes develop of disrespect for any property, and no effort is made to safeguard property or husband it. This situation leads, in turn, to iron-fisted policing by the state if socialism is insisted upon, and eventually that too fails.

Related to this idea of clearly defining property rights to increase property values is the notion of developing other public and private institutions in order to minimize transactions costs. An apartment that can be transferred with a simple contract registered with a "title" agency makes the property "worth" more than it would be in a system in which a large number of bureaucratic permits have to be secured before this transfer can be accomplished. The same is true with any permits a government may require for what would otherwise be a private transaction. The greater the time and cost required for accomplishing any agreed upon transfer, the less the property is worth.

Trial and Error

I have no doubt that perestroika will result in a large amount of trial-and-error experimentation, and I have no doubt that many Western institutions will be copied in a vain hope that they may perform as well in the Russian context. But there is probably no way to avoid an upheaval of sorts in replacing an almost totally planned economy with a market system, establishing a voluntary and private property regime where an authoritarian socialist perspective has dominated all thinking, and where political accountability will perhaps now substitute for a dominant ideological party's edict. No one should believe that this can be done easily, and I believe that it is foolhardy to propose measures, like the so-called cold turkey approach to perestroika, that will necessarily lead to public turmoil, chaos, and eventually tragedy.

Some acceleration of the usual slow evolutionary process that has characterized the development of Western institutions of private property is probably the best the Soviet Union can hope for now, a compromise, if you will, between productivity and security. And the optimal speed of the process can only be guessed at. Oddly enough, the less copying there is of specific foreign institutions and the more copying there is of a foreign ideology, the better chance perestroika may have.

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The Minimal Politics of Market Order

James M. Buchanan

> The economic progress of the twentieth century has fully confirmed that only a market economy is capable of ensuring high efficiency in national economy.
>
> —Leonid Abalkin[1]

Introduction

The basic meaning of Abalkin's statement, which I have used as my opening citation, is clear. As I have put the same point elsewhere, there is now general agreement that the market economy works better than the socialist or centrally directed alternative. Further, we now agree on what is meant when we say that an economy "works better." Such an economy produces a larger bundle of goods and services, as measured by the evaluations of persons who consume them. The economy organized on market principles produces more value than an economy organized on nonmarket principles.

Abalkin refers to "efficiency" in the production of value. A market economy is relatively more efficient for three reasons: It makes the incentives of participants compatible with the generation of economic value; it exploits fully the localized knowledge available only to participants in separated decentralized circumstances; and it allows maximal scope for the creative and imaginative talents of all participants who choose to act as potential entrepreneurs.

I shall not discuss these familiar, and now acknowledged, characteristics of a market economy further. My purpose here is to suggest that over-attention to, and over-concentration on, the efficiency generating features of the market economy may prompt neglect of the

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[1]Abalkin (1990, p. 6).

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closely related corollary feature that is equally, if not more, important. The economy that is organized on market principles effectively *minimizes* the number of economic decisions that must be made *politically,* that is, through some agency that acts on behalf of the collective unit. In practical terms, we may say that an economy organized on market principles minimizes the size and importance of the political bureaucracy. If he had chosen to emphasize this feature rather than efficiency, Abalkin could have said: "The logic of the structure fully confirms that only a market economy is capable of allowing for a minimal politicization of the national economy." And should he have wanted to extend this statement, he might have added: "And only through such minimization of politicization-bureaucratization (or at least through some reduction) could meaningful individually based social objectives be secured, whatever these objectives might be."

In the second section of this paper, I shall describe the relationship between politicization and market organization as I develop the distinction between political pricing and market pricing. In the third section, I shall discuss the implications of political pricing for the whole set of relationships among citizens and groups of citizens in an economy. The analysis, which uses modern contributions of public choice theory, identifies sources of possible waste of economic value, as well as circumstances where persons are placed in dependency status in confrontation with others. The normative implications are evident. The fourth section discusses the necessary role of political or collective action in the design, construction, implementation, and maintenance of the structural framework within which any market economy is allowed to function. Collective choice among alternative sets of rules is required, but any such choice is constrained by feedbacks from value generation and from bureaucratic intervention. In the fifth section, I shall return to the distinction between political price and market price to illustrate how possibly agreed on "social" objectives might be advanced without overt politicization of markets. I shall also introduce the notion of a politically influenced market price, and I shall demonstrate the limits of applicability. The final section presents conclusions.

Political Price and Market Price

A characteristic feature of socialist regimes involves the use of politically determined prices for selected goods and services, presumably motivated by both distributional and paternalistic considerations. The goods and services so selected are made available to

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consumers at demand prices that reflect political judgments rather than the results that emerge directly from the interaction of demand and supply. The listing of such goods and services is empirically familiar: medical services, educational services, child care, urban transport, housing, milk, bread, and so forth. Some or all of these selected goods or services are made available to consumers or users at prices below those that would be established by market forces.[2]

Consider a single and highly simplified example. Suppose a collective political decision is made to supply bread to consumers at a price of zero, which may be called a "political price" because it is divorced from any relation between costs of production and demand. If political action is limited to an announcement of this political price, the response is readily predictable. Potential consumers will demand large quanitities of bread at the zero price, and there will be no potential suppliers willing to put bread on the market at that price. Political decisionmakers who initially try to meet potential consumers' demands must direct large quantities of resources into bread production, either by direct requisition or by some scheme for subsidizing potential suppliers. That is, even if sufficient bread is available to meet all demands at the artificial political price, some additional political action must be taken, over and beyond the setting of price itself, to make the pricing operational. Resources must be drawn from other uses into bread production, and demanders are encouraged by the artificially low price to use bread wastefully. (The illustration from Soviet experience that is often adduced here is the story of peasants feeding bread to cattle.)

As noted earlier, however, I do not want to stress the wasteful or efficiency-reducing effects of political pricing. Let us heroically assume, therefore, that political decisionmakers, the planners who act on behalf of the collectivity, direct resources into bread production in some rough approximation of the quantity that would be forthcoming under market pricing. This combination of zero-demand price, along with roughly optimal supply, will ensure the presence of two results: There will be an excess demand for bread, and the costs of producing and supplying that quantity must be financed from sources other than people who consume the bread. Political decisions and political actions are required on two institutional dimensions over and beyond the setting of price.

[2]Administrative inefficiencies in distribution may, of course, be so large as to make the inclusive prices for such goods higher than free-market prices, despite the intent of planners.

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We can compare such a regime of political pricing with a regime of market pricing by supposing that there is no politicized interference with the market for bread; thus the price is allowed to emerge from the interaction of demand and supply. In this setting, suppliers and producers may offer bread to prospective purchasers on terms of their own choosing, and potential consumers may choose to purchase or not, in whatever quantities they choose. We know that in this setting roughly the efficient supply of bread will be placed on the market ("efficient" as measured in terms of the value scales of demanders throughout the economy). In addition, under this regime of market pricing, the two results emphasized as characteristic of political pricing will be absent. There will be neither an excess nor a deficient demand for bread; there will be neither an excess nor a deficient supply of bread. And there will be no requirement that other persons in the economy, other than bread consumers, must finance the production of bread. The political decisions involved in (a) setting the political price, (b) allocating the available supply among potential demanders, and (c) financing the production of the available supply are unnecessary under the market pricing regime.

There are, of course, distributional differences between the two regimes. Those consumers who succeed in getting bread at zero price under the political pricing regime may be better off than they would be under the market pricing regime. (Although they need not be better off when the full price, including time in queues, is taken into account.) But these possible gains to consumers are fully offset by losses suffered by whomever in the economy must finance the supply that is made available. Political pricing must, in some sense, embody value transfers between users and nonusers of the goods that are politically priced. By contrast, no across-market transfers need take place under market pricing.

Political Pricing, Bureaucratic Discretion, and Social Waste

Market pricing incorporates two important coordinating functions that political pricing fails to perform. The available supply is rationed among potential demanders, and the quantity supplied is brought forth to meet the potential demand. If political price is set lower than market price, some means of rationing other than price must be brought into being, unless supply is adjusted to meet whatever demand emerges. In that case, massive waste of economic value must ensue.

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Under excess demand conditions, nonprice rationing may take any one of several forms, singly or in combination. Available supplies may be allocated by some explicit rationing mechanism, for example, by issuing ration coupons that are required for purchase. Or rationing may be accomplished by some variant of a first-come, first-served scheme that involves waiting periods and long queues in shops. Or, finally, the people who control access to supply may ration goods through private pricing. In each scheme emerges a necessary role for a bureaucratic agency that market pricing would make redundant.

Similar implications for the necessity of a bureaucratic agency emerge when we examine supply-side coordination. If voluntary adjustment to market-related supply price is not allowed to take place, producers must, somehow, be encouraged to bring forth the politically chosen quantity of goods. Production may be directly organized through state enterprise, or private suppliers may be subsidized. In any case, some collection of revenues from other sources in the economy is required, collection that, again, depends on bureaucratic agency. Or production may be directly requisitioned, in which case suppliers must be subjected to coercive bureaucratic command.

Political pricing requires an extended supplementary bureaucratic agency to achieve plausibly meaningful coordination of objectives. Individual citizens, not only as demanders and users of the economy's end items but also as suppliers of the inputs that are combined to produce such items, are necessarily subject to the discretionary direction of the bureaucratic agency to an extent not present under market organization. This dependency of the citizen on bureaucracy exists quite independent of personal behavioral characteristics of people in bureaucratic roles. Even if all those bureaucrats should behave ideally in terms of widely shared criteria of fairness, the dependency relationship continues to exist.

As modern public choice theory suggests, however, bureaucratic agents are not likely to be different from other persons in the community; at least, models of behavior should not be constructed that presume totally different behavior. The bureaucrat will, as will others, seek to maximize his or her utility subject to the constraints that are faced. And because the institutional structure under a regime of political pricing places other persons in a dependency relationship, the bureaucrat can scarcely be expected to refuse, deliberately, to exercise this power of discretion so as to maximize his or her own utility. Favoritism, discriminatory treatment (both positive and negative), and arbitrary classifications—these features are almost necessary characteristics of any system that places people in dependency

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relationships with bureaucrats who are living, breathing human beings.

These characteristics will be present in regimes of political pricing even if there is no corruption in the ordinary meaning of the term. Bureaucrats who possess discretionary authority to allocate or distribute access to economic value will, of course, have opportunities for pecuniarily beneficial trades for the simple reason that the allocative-distributive authority itself has value. And there is surely some positive correlation between opportunities for, and the exploitation of, gain.

But the problems of bureaucratic discretion do not lie exclusively, or even primarily, with bribery. First, these problems exist because of bureaucratic discretion itself, which implies that choices must be made among claimants on some basis other than economic value. In this respect, the introduction of bureaucratic discretion made necessary by political pricing becomes a source of the relative inefficiency of the whole structure. Second, the dependency relationship introduced between those persons who hold discretionary authority and those who are subject to that authority creates arbitrary class distinction. Third, and perhaps most important, the artificially created scarcities under political pricing become objects of socially wasteful investments. People find it privately rational to invest resources in efforts to secure differentially favored access to the economic power inherent in bureaucratic discretion. This rent seeking on the part of those who compete for the scarce access to valued goods (such as those who demand bread at the zero price) represents wasteful investment on the part of all people who are unsuccessful in the competitive effort.

There should be little or no dispute concerning the positive analysis of effects of political pricing on the size, range, discretionary limits, and secondary behavioral repercussions of bureaucratic agency. There are no normative implications to be derived directly from the analysis, as such. Nonetheless, to the extent that analysts and observers can agree that these effects are, in themselves, undesirable characteristics of political pricing regimes, the relative advantages claimed for such regimes in comparison with market pricing regimes are reduced in significance. The minimization of politicization-bureaucratization of economic interaction, which market pricing makes possible, must be reckoned to be a relevant factor in the ultimate comparative judgment over and beyond the closely related and more familiar argument from efficiency.

The Political Constitution of Economic Order

Until now, I have referred to regimes of political pricing and market pricing without direct mention (other than in my introduction) of

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the constitutional structure that defines the framework within which any regime of economic interaction operates. It is important to emphasize that political or collective action is necessary in establishing and maintaining the regime's structure, under any and all circumstances. The minimization of the range and scope of bureaucratic discretion, discussed in the previous two sections, refers exclusively to the setting for economic interaction within the structure of rules, that is, within the constitution of the economic order. As the analysis suggested, market pricing tends to minimize bureaucratic discretion relative to that which is required under political pricing. But market pricing will function effectively only within a set of framework rules that must, themselves, be established or maintained collectively. At the level of constitutional choice, there is no escape from politicization.

I shall limit my discussion to an outline of those features of constitutional structure that will allow market pricing to emerge and to function. I shall not discuss how the basic constitutional choice among sets of rules is made. First, there must be a dispersed and decentralized distribution of the capacities to produce economic value, along with an explicit political and legal acknowledgment of this distribution. Property or property rights, both in human capacities and in nonhuman assets, must be widely dispersed in ownership, and the pattern of ownership itself must be afforded explicit legal protection. Second, private owners must be allowed to exchange owned rights to property among themselves, and there must be political-legal enforcement of voluntary contracts made for the exchange of these rights.

Under such a dispersed, decentralized pattern of private ownership, along with political and legal acknowledgment, protection, and contract enforcement, the basic elements for the constitution of a market regime will be in place. Resource capacities will be allocated among separate possible uses; production will be organized through combinations of productive inputs; and goods and services will be produced, supplied, and priced to consumers who demand them. Nobody in either a private or a political role is directly required to attend to the particular features of the outcome, or pattern of outcomes, of the interdependent market process. This outcome, or pattern of outcomes, will emerge from the interactive, interdependent choice behavior of many persons. The allocative and distributive results will be chosen by no one.

It is precisely at this point that an overemphasis on the efficiency criterion for evaluating the performance of a market economy may be misleading. The efficiency that is, indeed, achieved by market

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interaction is, itself, defined by such interaction. The value scale emerges from the market choices made by all participants; such a scale does not exist independently. There need be no relationship between the performance of a market economy and the efficiency relative to a value scale chosen by the planner or political decision-maker. Only if decisionmakers are willing to allow the market itself to define efficiency can Abalkin's statement be valid.

A market order, of sorts, will emerge once the basic elements are in place. But the constitutional structure may be extended to include other rules or institutions that may be expected to facilitate the inclusive exchange process. The political agency, the state, may take on the responsibility of defining the monetary unit for the economic order and may, ideally, seek to maintain stability in the value of such unit. There may also be specialized institutional arrangements aimed at promoting competitive forces, especially those that promote freedom of entry into production and that prohibit cartel agreements. Other collectively consumed or public goods (for example, protection of environmental quality) may be brought within the state's authority, and constitutional rules may be introduced that specify the means through which state supplied goods and services are to be financed.

Minimal Bureaucratization and the Social Market Economy

Attention to, and emphasis on, the relationship between the coordinating properties of market pricing and the range of bureaucratic discretion have implications for the efficiency of political intervention that may be undertaken in the furtherance of social objectives. Political decisionmakers, either those who act as agents for a ruling elite or those who claim to represent electoral constituencies in democracies, may reject the efficiency norm as defined by operation of the market economy, even if the collectivized sector is extended to include the financing of non-excludable, collectively consumed goods. These agents, for the same distributional and paternalistic reasons that motivated many of the socialist experiments in economic dirigisme, may seek to use political authority to modify, at least in part, the results of the market system.

At the same time, the advantages of market organization both in generating economic value and in minimizing the role of bureaucratic discretion may be accepted. How might the coordinating properties of markets be retained while using political authority to modify the distributive-allocative patterns toward those patterns more desirable to decisionmakers (planners)?

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Suppose that the basic structural rules of a market economy are established. Property rights are then decentralized, and voluntary contracts are enforced. Recall my earlier discussion in the second and third sections. If supplies are sufficiently provided to meet all demands at the politically determined demand price that faces potential consumers-users, there is no need for a supplementary rationing scheme. If all supplies offered at the politically determined supply price are taken, there is no need for rationing sales permits among potential suppliers. Price may be used, therefore, both to ration demand and to stimulate supply. But the additional market equilibrium characteristic may be absent. The demand price at which a good is offered to consumers may not be brought into equality with the supply price offered to suppliers. As noted, under any scheme of political pricing, some cross-market transfers of value must take place. If the political decisionmakers encourage market participants to purchase more of a good than their preferences will dictate in an undisturbed market pricing structure, a wedge must be driven between the demand price at which the good is offered to consumers and the supply price that is offered to producers. The demand price must fall below the supply price. Even if these separate prices fully accomplish their rationing function, means must be found to finance the difference.

The political decisionmakers must, in this case, be willing to introduce a wedge of the opposing direction in the market for some other good (or goods). That is, the demand price must be made higher than the supply price in some other market (or markets) to generate the revenues sufficient to finance the subsidy for the favored good or service. As in the first market, prices can be used to eliminate the need for bureaucratic discretion in supplementary rationing roles. But recognition of the across-market transfer of value here suggests that the budget must balance. That is, the revenues collected from the disfavored good must be precisely equal to the subsidies paid to the producers and consumers of the favored good. Production and consumption of one good can be encouraged; production and consumption of the other good can be discouraged. The alleged social objective can be accomplished within the set of constraints imposed by participants' preferences in the economy in their roles as demanders and suppliers of the two goods (or bundles of goods).

A Tale of Bread and Vodka

The discussion here may be clarified by a simple example. Suppose the political decisionmakers, whoever they may be, modify the allocative and distributive results of the market economy in a specific

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way. The declared social objective may be to encourage the production and consumption of bread, to discourage the production and consumption of vodka, and, at the same time, to minimize both efficiency loss and bureaucratic discretion.

Bread production may be differentially subsidized, and vodka production may be differentially taxed. Under such arrangements, both goods continue to be marketed at prices that are politically influenced although they remain, in one sense, market prices. For such a scheme to work effectively, the two sides of the account must balance. Further, the solution must be brought into adjustment with the demand and supply schedules of both goods, as revealed through the independent behavior of demanders and suppliers.

The political decisionmakers cannot simply impose a per unit tax on vodka independent of the per unit subsidy on bread. Given the behavior of vodka demanders and suppliers, any specified tax per unit on vodka will generate a defined revenue total that will be available for subsidizing bread. But the size of the per unit subsidy will depend, in this case, on the behavior of demanders and suppliers of bread. Political decisionmakers cannot simply select any per unit subsidy for bread, if they want to minimize the need for bureaucratic discretion in bread distribution. Conversely, any preselected per unit subsidy on bread will, given the behavior of demanders and suppliers of bread, require a defined revenue outlay. So that this outlay may be financed from the tax on vodka, the per unit size of this tax will be fixed, given the behavior of demanders and suppliers of vodka.

Political decisionmakers might desire many solutions that may simply be inconsistent with the behavior of participants in the economy. For example, revenues required to finance a full subsidy on bread, to allow it to be offered at a zero price as in our earlier illustration, may be beyond the limits that could be generated by a tax on vodka. The demand and supply behavior of participants in all markets, which must be allowed to take place without bureaucratic coercion, will place constraints on the ability of political decisionmakers to modify market results. Within such limits, the structure of market prices may be very substantially modified in presumed furtherance of social objectives.

Conclusion

In any economy, resources must be allocated and combined to produce useful outputs that must, in turn, be distributed to consumers. An economy that is organized on market principles will accom-

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plish this set of tasks more efficiently, more economic value will be generated, than in a centrally directed economy. My purpose has been to emphasize the importance of the corollary feature of the market economy, which relates the organization of the economy to the range of political and bureaucratic discretion. If resources are not allocated and products distributed through the workings of a market system, then the allocative and distributive functions must be performed directly by a political-bureaucratic agency. In this direct and obvious sense, markets, to the extent that they are allowed to operate, constrain bureaucratic intervention into the lives of citizens.

This conclusion does not imply that markets or market organizations eliminate, as if by magic, the elemental constraints imposed by scarce resources. By increasing efficiency in resource use, markets may reduce the severity of these ultimate constraints. Yet the basic limits on resources remain; markets replace the implementation and representation of constraints through coercive intrusion of personalized bureaucracy by the impersonal price structure. The discretionary power or authority of the bureaucrat is replaced by the impersonal authority of prices, with the accompanying differences in interpersonal relationships.

The market order minimizes the range of bureaucratic discretion, but this order operates only within a constitutional framework that must be politically established and sustained. The basic elements—dispersed private ownership of property and enforcement of contracts—are necessary to allow markets to emerge and to generate patterns of outcomes upon which preferences of participants place the highest value, as expressed through market behavior.

Politics, as it operates and no matter how the decision structure may be organized and how decisionmakers are selected, may not willingly confine its activities to establishing and maintaining the constitutional framework. Politicians, both on their own account and as representatives of constituencies of citizens, may seek to modify some outcomes that would emerge from the uncontrolled workings of market process. Many citizens may share in categorizing certain goods as "worthy of encouragement" (sometimes called "merit goods") and other goods as "worthy of discouragement" (sometimes called "sumptuary goods"). In almost every polity, attempts will be made to modify the results of market interaction to encourage the first set of goods and to discourage the second set.

There are better and worse means of intervening in the workings of markets if minimizing bureaucratic discretion along with efficiency is accepted as a norm. The objectives for a social market economy may be furthered by schemes of appropriately selected taxes and

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subsidies that are adjusted to the demand and supply behavior of participants.

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The Political Economy of Transition to the Market

Boris Milner

Political Decisions and Market Decisions

It was with great interest that I have read James Buchanan's paper. His subtle, original, and unbiased analysis of the mechanisms of central planning and of the market economy goes far beyond the usual comparisons, not only in its acute relevance but also in the novelty of many of his premises and conclusions.

The basic premise of the paper is an expansive interpretation of the efficiency of a market-type economy. The familiar criteria involving the production of goods (the incentives of economic agents, full use of information in a decentralized system, the room given creative and inventive abilities) are broadened by Buchanan to add and analyze the effect of another factor: the relation between political decisions and market decisions.

It is here, I believe, that the principle he formulates is of fundamental importance:

> The economy that is organized on market principles effectively *minimizes* the number of economic decisions that must be made *politically*, that is, through some agency that acts on behalf of the collective unit. In practical terms, we may say that an economy organized on market principles minimizes the size and importance of the political bureaucracy.

This general conclusion is true when all else is equal, when two fully formed economic systems—a state planning system and a market system—function autonomously in parallel ways, each within its own regime and its own established rules of behavior.

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Transition from Plan to Market

But there is probably a need for additional analysis of *transitional regimes,* of the establishment and development of one system through the removal of the functional mechanisms of the other. It is here that a number of characteristic features and specific qualities of the period of transition to the market, which our economy is now undergoing, deserve to be taken into account.

The first characteristic is the uniqueness of the transition itself; hence, we have the lack of theory and procedure for transitional states, and the impossibility of learning directly from accumulated historical experience. This transitional period is unique because no other country in the world has ever had to move toward the market through the break-up of supermonopolistic hierarchical structures of commodity producers and commodity distributors, structures painstakingly erected over many decades. There is not a single country that, on its way to the market, has had to change the rules of behavior of the economic system in a short time, breaking firmly cemented administrative ties and anti-economic relations. No one else, on the way to the market, has had to overcome a mentality of command and subjection that has penetrated deeply into the minds of millions over the lives of at least three generations, and has become a historical stereotype.

Hence, we find the incredible complexity of the task, the constant necessity of choice among many possible decisions, the inevitable emergence of restraining mechanisms slowing down change, and the need to overcome obstacles. Moreover, we see that the search for new ways cannot be systematically fitted into a ready-made scheme, program, or course of action. Clearly, there is no program that could anticipate every detail, take note of every link, or avert any unforeseen foul-ups or miscalculations.

Of course, in such a situation, one cannot count on the relation between bureaucratic management (or "political pricing") and market mechanisms to be stable at all times. The liberalization of pricing will take time; we are facing a step-by-step transition to free prices on many commodities.

Nor can one fail to notice another characteristic: The establishment of economic relations is being initiated and carried out less through spontaneous and natural development "from below," among primary economic agents, than "from above"—both by the central authorities and by the republican and regional ones. Those authorities believe they are needed to dismantle the old administrative structures and to legally institute and protect the newly emerging market economy.

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This process, to use Buchanan's expression, must lead to the creation of a "political constitution of economic order." That is why it seems to me that, with regard to the current starting conditions of the transition to the market, the following passage in Buchanan's paper should be considered extremely topical: "Market pricing will function effectively only within a set of framework rules that must, themselves, be established or maintained collectively. At the level of constitutional choice, there is no escape from politicization."

It is within this framework that answers to the questions of (a) how to minimize political influence on economic ties and relations, (b) how state regulatory agencies are to function in a market economy, and (c) how to make the transition from vertical to horizontal relations are to be sought.

There are, essentially, two ways: (1) Political institutions and their functions emerge from within the market economy, to serve the interests of free enterprise; (2) government structures of nonmarket relations and centralized allocation of resources change their nature and are transformed into political institutes serving the interests of the market.

Neither of these ways can succeed by itself, in unadulterated form, since we are dealing with a very complex, broad, and ramified system of administrative connections and hierarchies established deliberately and consistently. That is why the multichannel processes of transition to new governmental structures and the emergence of economic agents have already begun and must unfold simultaneously.

One of the tendencies is the elimination of structures adapted to "nonmarket relations" and the creation of minimally necessary new ones. Another direction is the establishment of parallel structures and the gradual replacement of old agencies by new ones. Yet another way is the transformation of government structures into economic agents performing within the framework of a market economy and run on a democratic basis.

Other approaches are possible as well, but it is already clear that a period of transition is inevitable, with old and new structures coexisting side by side and the new edging out the old as market relations take root and develop, and as market agents themselves—firms, concerns, consortiums, economic associations, joint-stock companies, commodity and financial exchanges, commercial mediators, small enterprises in various spheres—gather strength.

This transition means the development of conditions that, as Buchanan asserts, remove the necessity for political decisions related to the fixing of political prices, the allocation of available resources

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among potential users, and the "financing" of the production of the goods being allocated.

The Transformation of Government

During the transition period, the discretion and tasks of the central government diminish. Its functions are reduced primarily to overseeing market activities—for example, limited administrative regulation; supervision of the financial, credit, and tax systems; and the maintenance of a basic social safety net. The economic powers of the center represent the sum of powers delegated by sovereign republics.

Within the framework of those powers established by agreement, the central government exercises its authority in overseeing all-Union properties and funds and economic programs on an all-Union scale, and also ensures the greatest possible coordination in carrying out reform. In all these processes of the institutionalization of the market, it is very important to constantly emphasize, as Buchanan does, "the importance of the corollary feature of the market economy, which relates the organization of the economy to the range of political and bureaucratic discretion."

The formula offered by Buchanan is inexorable: "If resources are not allocated and products distributed through the workings of a market system, then the allocative and distributive functions must be performed directly by political-bureaucratic agency. In this direct and obvious sense, markets, to the extent that they are allowed to operate, constrain bureaucratic intervention into the lives of citizens."

Agencies of direct bureaucratic control over enterprises are exiting the stage; the very subordination of economic agents must disappear, and agencies of a new type will emerge: a state treasury, a small business assistance administration, an antitrust agency. The restructuring, streamlining, and transforming of government structures and their functions are only beginning. These are the processes that must blaze the trail toward a fundamentally new relationship between political and economic pricing, toward the minimization of government interference in price-setting.

Thus, if we speak of "politically influenced market prices," we should very definitely proceed from the premise that prices are influenced by general economic policies as well as by government policies affecting prices: deductions from profits or revenues, taxes, tariffs, subsidies, and so on. But how does one move on to such a

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system today, in the specific circumstances of a profound economic crisis?

The Pricing Problem

There are three conflicting approaches currently under discussion:

1. The transition to the market should begin with a general price reform (a one-time price hike with compensatory income supplements for the population.
2. Price reform should take place after the stabilization of the financial and credit systems and of the monetary cycle, and after the elimination of government monopolies.
3. A step-by-step transition to free prices should occur without an administratively imposed price hike.

It is in the light of these approaches that the transition period, in which both the nature and the range of "political influence on market prices" will undergo changes, should be considered. These parameters are becoming changeable and dynamic. Various options, including compromises, are possible.

What is especially characteristic of, and important for, such "influence" today? I would name the following:

- coordination of financial, credit, currency, and tax policies;
- legislative regulation of economic activities and free enterprise, promotion of competition, consumer and environmental protection;
- the creation of a market infrastructure;
- a drastic reduction of the government budget deficit and "tying down" excess money;
- organic linkage of the transition to market pricing to the demonopolization of the entire system of economic ties between enterprises, organizations, and the population.

The Question of Social Protection

Programs softening the negative impact of economic reform are designed to provide social protection to the population. The population is especially sensitive to such programs since this is a question of ensuring a guaranteed minimum standard of living.

The transition to the market is being carried out today not only in the midst of a profound economic crisis, disintegrating economic ties, political instability, and ethnic tensions, but also in an extremely unfavorable social and psychological environment.

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If the price of reform is too high for the population, there is a very high probability of the emergence of protest movements in a variety of forms, of growing resistance to economic restructuring. Prices and incentives, prices and social climate—these problems will be in the forefront during the entire period of transition to the market.

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The Soft Infrastructure of a Market Economy

William A. Niskanen

A Western economist's first visit to a socialist nation is an eye-opening experience. One's first impressions are rather like those from visiting the poorer regions of our own economies—most visibly the lower levels of creature comforts, health, and environmental conditions. It would be a mistake, however, to explain the differences between the market and socialist economies in terms of the conditions that explain the differences over time or among regions in the productivity and average income within a market economy.

An economist studying a market economy, for example, is most likely to focus on the differences in human skills, private and public investment, and natural resources, and the incremental or small differences in government policy. We are less likely to study the basic institutions of a market economy, because they have changed only gradually over time and are common across the nation. Indeed, our standard graduate training in economics hardly mentions these institutions, and few economists have more than a shallow understanding of their importance.

The most important differences between the market and socialist economies, however, are the less-visible or quantifiable differences in these basic institutions. I am not a specialist in the socialist economies, so my understanding of the Soviet economy is necessarily secondhand. For the past several years, however, the inchoate reforms in the socialist economies and my own brief visits to several other socialist economies have led me to reflect on the basic institutions, or "soft infrastructure," of a market economy. The present paper gives me an opportunity to share my reflections in a systematic way.

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The Legal System

One of the three basic institutions of a market economy is the legal system. Specifically, a market economy is dependent on a comprehensive commercial code and a system of commercial courts to adjudicate disputes. A modern commercial code includes the laws bearing on property, contracts, torts, and those laws specific to the several major types of business enterprises. For this system to be fully effective, property rights should be

- *exclusive*—to provide clear title for the authority to use or sell specific rights;
- *alienable* (sellable)—to permit market exchanges of specific rights;
- *partitionable* (separable)—to permit the separation of a specific right from a package of rights; and
- *extensive* (universal)—to permit market exchanges of all valuable resources, a necessary condition to avoid the abuse of "common pool" resources that is characteristic of environmental problems.

In effect, the political economy of a nation is defined by the nature and distribution of these rights. The distinctive principle of a market economy is that any *change* in the distribution of rights must have the consent of *all* those who own the affected rights.

An American economist is reluctant to conclude that any nation might have too few lawyers. Our army of lawyers is about as large as the U.S. Army and is almost as dangerous. The socialist economies, however, clearly need to extend and refine their commercial codes. The following examples might be helpful.

Although most property in a socialist economy is nominally owned by the state, it is often not clear whether the workers, the local manager, some party official, or the relevant minister has the authority to sell the property and who is to receive the proceeds. This ambiguity has already created cases in which two firms have purchased the same property from different officials, with no clear process for adjudicating the title dispute. The important but necessarily complex process of privatization will be undermined if the general population perceives the initial distribution from the sales to be unfair. A strong assertion of clear title by the state may be the necessary, but somewhat ironic, first step to effective privatization.

In some cases, rights have been granted to farmers or cooperatives to use property but not to sell it. This situation generally leads to inadequate maintenance of the property, most visibly demonstrated

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by the Yugoslav experience. In other cases, rights have been granted as a package but without the authority to sell specific rights to others. This condition leads to an underutilization of those specific rights that the owner is less qualified to use. In all nations, the most egregious environmental offenders are state firms, primarily because governments have exempted these firms from legal suits or from the regulations that apply to other firms.

A closer look at the Soviet economy would surely produce more examples. My main point is that many of the apparent problems of the socialist economies could be reduced by extending and refining their commercial codes. The Soviet Union should not try to copy the Western commercial codes; the U.S. code, specifically, is too complex and involves too much litigation. Nevertheless, there is a rare opportunity to learn from both our successes and problems. President Gorbachev has pledged to restore the rule of law in the Soviet Union. That task will not be complete until it is extended to the full range of economic rights and relations.

The Accounting System

The second basic institution of a market economy is the accounting system. Specifically, a market economy is dependent on the broad use of a common set of financial accounting rules and an independent system to audit financial reports. The two common reports are a balance sheet (a statement of the value of a firm's assets and liabilities at the end of the prior period) and an income statement (a record of the receipts and expenditures during the period). These reports, with additional internal information, are used by a firm's directors and managers to determine the costs and profits on specific products and the financial performance of component divisions. More important, these reports are critical to a bank or other firm that is considering a loan to or investment in the firm. The accounting rules and auditing systems have evolved over the many years and are not perfect, but one cannot imagine a market economy without a similar set of financial records.

My conversations with Western entrepreneurs who have considered joint ventures with socialist firms, however, indicate that the accounts of these firms are almost worthless, either for internal management or external monitoring. In most of the socialist nations, the accounts of state firms are designed and maintained to provide the insatiable data demands of the state planning system. Most of these data bear on physical flows and are of little use to estimate the costs or profits of individual products or the financial status of the firm,

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even if the input and output prices were closer to market rates. Indeed, I am informed that the balance sheets of many state firms do not include a measure of net worth. At an earlier, more innocent, time, computers were expected to solve the massive data processing problems of a socialist economy. The problems of a socialist economy, however, are not from the lack of data; indeed, socialist economies are drowning in data. The problem is that these data convey so little relevant information.

One of the major advantages of a market economy is that it minimizes the necessary data flow, since prices convey most of the information necessary to coordinate economic activity among firms and with consumers. A financial accounting system, in turn, provides the information necessary for firm managers to respond correctly to the market prices of inputs and outputs. A major program to train accountants and develop modern financial accounts would be among the highest return investments in the Soviet economy.

Cultural Attitudes

The third basic institution of a market economy is the set of cultural attitudes. Again, this institution is one that Western economists take as given and, as a consequence, have often not understood its importance. The German liberal Wilhelm Ropke (1954) may have best expressed the importance of a specific set of cultural attitudes in concluding that

> An intensive and extensive economic exchange cannot exist or last very long without a minimum of natural trust, confidence in the stability and reliability of the legal-institutional framework (including money), contractual loyalty, honesty, fair play, professional honor and that pride which makes us consider it unworthy of us to cheat, to bribe, or to misuse the authority of the State for egoistic purposes.

In turn, the single condition that most distinguishes a modern market economy from an oriental bazaar is the mutual desire for continued relations. I learned this lesson late. As chief economist of the Ford Motor Company, I was surprised to learn that Ford made billions of dollars of purchases a year from regular suppliers over the telephone with only the skeleton of a contract and with few contract disputes. The mutual desire for continued relations was what enforced the performance of both parties in each transaction. At any time that either party expected to end the relation or expected the other party to end the relation, moreover, the primary remaining discipline on the immediate transaction was the value of the firm's

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reputation with other parties, not the protection of the formal contract. Only when Ford made a major purchase without the expectation of a future relation was the contract extensive and often disputed. The cultural attitudes that contribute to this "evolution of cooperation" are subtle but simple: a mutual commitment to *exchange* (rather than threat) as the primary means to coordinate economic activity, the self-restraint to leave something on the table for the other party in each transaction, and the use of the authority of the state only to discipline gross or repeated breaches of contract.

Ropke was most perceptive about the requisite cultural attitudes for a market economy. But he did not develop on those attitudes that would prevent or destroy a market economy. The one attitude most incompatible with a market economy is a profound and pervasive sense of envy. A society can survive pervasive egoism; indeed a market economy relies on it. A market economy, however, cannot survive the leveling instinct, the concern that your neighbor or former schoolmate might be doing better than you are. One should not be surprised that all of the major religious traditions regard envy, covetousness, or resentment as a major sin. Envy is a human condition, but it is most destructive of social organization. Envy, combined with the erosion of the constitutional limits on the powers of government, has progressively weakened the Western market economies. And envy may prevent the development of stable market economies in some of the current socialist nations. I am disturbed to hear of old Russian folktales in which the peasants prayed, not for a good harvest or a fecund herd, but for their neighbor's barn to burn or for their neighbor's goats to die. As Ropke observed, it is important not to "misuse the authority of the State for egoistic purposes." It is also important not to misuse the powers of government as an instrument of envy.

Conclusion

In summary, the three basic institutions—the requisite soft infrastructure—of a market economy are the legal system, the accounting system, and the cultural attitudes. I have purposefully avoided a ranking of the importance of these three institutions. In combination, these institutions are rather like a three-legged stool, in that any one short or weak leg seriously reduces the stability of the stool. Individual and state investment in these three institutions is far more important than the other elements of a radical perestroika; indeed, these three institutions are requisite to the success of the other measures.

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The Pursuit of Happiness under Socialism and Capitalism

Charles Murray

> Men are not tied to one another by papers and seals. They are led to associate by resemblances, by conformities, by sympathies.
>
> —Edmund Burke

There are many practical problems that the Soviet Union must address concretely in the months to come: questions about how to organize a political system so that the people's interests are represented effectively, how to organize an economic system that produces prosperity, and how to organize an international system that not only prevents war but also establishes harmony. These are questions of considerable importance. But let us take a break from these practical affairs and think about something that seems at first glance to be impractical, subjective, unscientific—the stuff of daydreams and yearnings. Let us talk about happiness. More specifically, let us talk about what the American Declaration of Independence calls "the pursuit of happiness" and about how a government can help or hinder its citizens in that pursuit.

It is a question that may seem irrelevant to the Soviet Union in the fall of 1990. The Soviet people are demanding more and better food, shelter, and consumer goods. If the Soviet government can succeed in meeting those concerns, one may argue, happiness will take care of itself. That statement is surely true if one is talking about the immediate future. By all means, the Soviet Union should concentrate right now on raising its people's standard of living. But what of the future? A well-known American psychologist, Abraham Maslow

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(1943, pp. 374–75), evocatively stated the distinction between short-term and long-term needs. Consider the case of a man who is chronically hungry, Maslow wrote. For him,

> Utopia can be defined very simply as a place where there is plenty of food. He tends to think that, if only he is guaranteed food for the rest of his life, he will be perfectly happy and will never want anything more. . . . Freedom, love, community feeling, respect, philosophy, may all be waved aside as fripperies which are useless since they fail to fill the stomach.

Right now, the average Soviet citizen seems to be in an analogous position—if not hungry for bread, hungry for a better apartment and a videotape player. The next statement by Maslow (1943, pp. 374–75) seems especially pertinent: "It is quite true that man lives by bread alone—when there is no bread. But what happens to man's desires when there *is* plenty of bread and when his belly is chronically filled?"

The question is especially appropriate to ask in the city of Moscow, the Third Rome. It is especially appropriate to ask in the land of Pushkin and Lermontov, Tolstoy and Dostoyevsky, Moussorgsky and Tchaikovsky, Pasternak and Solzhenitsyn. The heritage of Russia is not materialism but spirituality. The great questions of the fate of the Soviet Union must ultimately be cast not in terms of its ability to provide bigger cars and better housing, but in terms of its ability to provide a satisfying life for the soul. This is the issue I take up here with regard to the role of government, briefly and incompletely setting out some important questions rather than giving full answers.

I will state my central thesis directly: The ultimate reason to adopt a system of limited government that protects a free market and private property is not to increase economic production. The ultimate reason is that such a system better enables its citizens to live together harmoniously and to fulfill their potential as human beings—in short, to pursue happiness. Centralized governments in general, and socialist governments in particular, inherently impede the realization of these goals.

A Definition of Happiness

First, we need to define "happiness" so that we may proceed from a common understanding of the topic. Happiness is defined simply and unrestrictively as "lasting and justified satisfaction with one's life as a whole." Mine is not a novel definition. It fits comfortably within the Aristotelian tradition of happiness that has so dominated Western culture since the *Nichomachean Ethics*. It also seems to

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fit what most ordinary people have in mind when they talk about happiness, as I discovered a few years ago when I told friends that my next book was going to be about the pursuit of happiness. Invariably, they reacted with dismay. Most people, they said, had a shortsighted, shallow view of happiness. But then when I asked my friends, "What do *you* mean by happiness?" their answers were remarkably similar. Their own definitions were not materialistic or shortsighted at all. The concept of "satisfaction" was almost always central to their descriptions of happiness: They did not consider happiness to be synonymous with pleasant sensations in their nerve endings. The concept of duration was usually part of their discussions: Almost everyone saw happiness as defined over the long term. And the concept of wholeness was important: Almost everyone thought of happiness as something that is defined in terms of one's life as a whole, not just one part of it.

Thus when I treat happiness as consisting of lasting and justified satisfaction with one's life as a whole, I am simply putting into words a common understanding. The definition has just one troublesome aspect, represented by the word "justified." "Justified" means that it is not enough to *feel* happy; one must have a plausible *reason* for feeling happy. A person who claims that he can be happy by injecting himself with a drug that causes perpetual euphoria is wrong. I take my cue from Aristotle and his insistence that human happiness must be linked to that which makes a human unique: the capacity for rational thought. Happiness must consist of something more than feeling good.

Practically speaking, "happiness" as I am using the term, might mean having a spouse and children in whom one takes joy. It might mean a job that one finds challenging and rewarding. It might mean the satisfaction of friendship, of being a valued member of one's community. In using this approach to happiness, I am also accepting that happiness is never an object that can be captured. All of us have good times and bad, highs and lows. Some people live unhappy lives for reasons over which they have no control. The classical Greek dramatists told us to count no one as happy until that person is dead. Without being a Greek fatalist, I accept that happiness is an edifice, built up slowly and often recognized as happiness only when we have a chance to look back on our lives and evaluate them.

Delimiting the Topic

Armed with this common-sense definition of happiness, we now turn to the question of how governments aid in the pursuit of

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happiness and how they impede it. This question could take us down many roads, but in this brief presentation I must be selective. I will focus on the ways in which governments aid and impede human beings in developing intimate, rewarding relationships with the people around them. I choose this topic partly because it is so important in itself. If we are so fortunate in life as to have intimate, rewarding relationships with friends and family, that good fortune alone is a major constituent of happiness.

But I choose this topic for another reason as well. In many ways, our relationships with other human beings constitute the master resource that we use in the other ways of pursuing happiness, be they making money or achieving self-respect or doing fulfilling work. Human relationships constitute the master resource because, necessarily, *people pursue happiness by actions, and these actions are usually social.* Most of what an individual might find important to his happiness, whether a loving family or fame or riches or helping others, can be achieved only through social interactions with other human beings. The only exception I can think of is the person who finds happiness in being a hermit, and the number of such people is exceedingly small. Thus I will focus on one element of the pursuit of happiness: the development of intimate and satisfying relationships with other human beings.

The Pursuit of Satisfying Human Relationships under Socialism

As intellectuals of the 19th century looked around them, they saw industrialization destroying traditional communities and relationships, uprooting families, and alienating workers. Socialism attracted these intellectuals not because of its promised economic efficiency, but because of its superiority as a way for human beings to live together, as its very name, "social-ism," reveals. Socialism promised not only to heal the wounds of capitalism, but also to enhance human interactions, bringing people together in a classless, noncompetitive social order.

Without arguing about the conditions that actually prevailed in the 19th century, I can safely say that, empirically, socialism failed to deliver on its promise of classless, harmonious human relationships. This failure is no accident nor is it the result of a failure to implement socialism properly. Rather, I will argue that the moral ideals of socialism are themselves to blame. The ideals of socialism push people apart. Socialism atomizes.

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The Egalitarian Ideal

This logic applies first to the ideal of egalitarianism. One of the most divisive of human emotions is envy, and the ideal of egalitarianism, translated into political terms, is an engine for generating the maximum amount of envy. Herein lies the problem: If equality is a moral ideal, any specific instance of inequality is morally suspect. It is impossible to be innocently better off than another person. Let me give you a personal example that you may apply to the Soviet Union. The person who lives two houses up from mine has a small swimming pool—the only swimming pool in the little town where I live. He is not rich. He does not have any political influence. He just went out and got a loan from the bank (I suppose) and hired someone to build his swimming pool. Several people in town could afford to do the same thing if they wanted a swimming pool badly enough, but apparently they do not.

My point is that my neighbor *innocently* has a swimming pool. There is no moral judgment to be made about it. It was his choice, his money, his house, and whatever he wants to do with it is his business. My question is, Is it possible for someone in a socialist society innocently to have a swimming pool? Innocently to have a Mercedes? Innocently to have a dacha? For that matter, is it possible innocently to have a better kitchen than one's neighbor? Perhaps I misapprehend the situation, but my impression is that if I have such things in the Soviet Union, I am likely to be an object of considerable envy among my neighbors who do not possess such things. Under a state with an egalitarian ideal, I am arguing, this envy is entirely understandable. If one person has a Mercedes when his neighbors still have to take the bus, then he is behaving "wrongly"—in violation of a moral ideal—no matter how he got the money to buy it. How is a good citizen supposed to react to this inequality? In some sense, he is obliged to react with suspicion and envy. Suspicion and envy are not only the logically correct reactions, they are the "moral" reactions.

The envy generated by the ideal of egalitarianism explains the phenomenon that the Soviet Union is now encountering. Consider, for example, the reaction of many Soviet citizens to the cooperatives. According to stories reaching the West, successful cooperatives are causing widespread resentment among Soviet citizens. Though a cooperative provides a needed good or a needed service, and even though this good or service is one that cannot be obtained elsewhere, many Soviet citizens are reportedly upset when the owner of a cooperative makes money.

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Westerners are told that the reason for this resentment is a deeply embedded Russian suspicion of profit. Upon hearing this, many Westerners think they know the solution. The resistance to cooperatives is a matter of ignorance, these Westerners say. Soviet citizens have been taught from their earliest years that profit is an intrinsically bad thing, that profits come from exploitation, and that profits occur only when one person has the economic upper hand over another person. The average Soviet does not understand that a voluntary economic exchange benefits both parties. I think this explanation misses the point. Even if the average Soviet can be convinced that the economic exchange benefits both parties, the source of resentment remains if one person seems to benefit more than the other. The source of resentment lies ultimately in the assumption that equality is a morally desirable state in itself.

Nor is this problem lessened as societies make more progress toward achieving egalitarianism. Sweden currently offers an intriguing look at this dilemma. Sweden has been successful in narrowing the range of real incomes under conditions of affluence. The Swedish standard of living is high; even the poorest families live well by international standards. The question then becomes, How is the quality of human relations affected? The anecdotal evidence is that Sweden is not becoming a warmer, more harmonious society as egalitarianism advances, but less so; envy and suspicion and rudeness are not diminishing, but increasing. Without claiming more, for I am not an expert on Sweden, let me suggest an explanation of why human relationships must inevitably deteriorate in every country that seeks egalitarianism. Namely, the egalitarian ideal wants people to be equal, and the reality is that people are *not* equal. They are not equal in tastes, talents, aspirations, industriousness, kindness, or any other human quality. On the contrary, they are infinitely diverse. A society must be constructed to provide a legitimate way for these infinitely diverse ways of being human to express themselves, for the same reason that the boiler of a steam engine must have a pressure valve—otherwise, it will blow up. The expression of individuality must mean inequalities in the things people do and the things people have. Conversely, the more successfully a society achieves material egalitarianism, the greater the resentment toward any inequalities that remain, and the greater the pressure that begins to rupture other portions of the social fabric and to rupture human relationships as a by-product.

The Ideal of Total Social Obligation

The famous dictum, "From each according to his abilities, to each according to his needs," offers an even more powerful reason why the

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ideals of socialism—Marxist socialism in particular—tend to atomize human beings rather than to draw them together. In this case, the moral demand that socialism makes is unreasonable by being too openended and too morally all-encompassing. It causes human beings to minimize their internal definition of their abilities and to define their needs competitively with their neighbors' needs. Once again, my argument goes back to some basic issues of human nature. In this case, I am arguing that an intrinsic part of human nature is to rationalize our internal beliefs so that we look good in our own eyes. We all want to think well of ourselves, if we can possibly figure out a way to do so. The "from each according to his abilities" requirement forces any ordinary person, short of a Stakhanovite, into an impossible position.

Suppose, for example, that I were to be transformed into a good citizen of a Marxist state and had been taught from childhood that to be a moral person I must give to society according to my abilities. What am I to do? I am not referring here to the way I present myself to the outside world. Rather, how do I, wanting to think well of myself as a moral creature, internally reconcile my talent and energy with the all-encompassing moral demand, "from each according to his abilities?" In a society without that moral demand, no problem arises. I can be grateful for whatever talent I have and can perhaps want to do something to benefit society in gratitude for my good fortune. But whatever I choose to do for society is my choice. I can apply my talent to my work, along with taking pride and pleasure in my accomplishments, without feeling guilty about anything.

Confronted with the "from each according to his abilities" moral ideal, I face a much different situation. For example, do I define my workday "according to my abilities" and conclude that I am obligated to work 12 hours a day? Of course not. As it happens, I actually do work 12 hours a day most days—but if tomorrow I were told I *had* to work that much to make my fair contribution to society, I would immediately say to myself that I was being exploited, that society had no reason to think I was capable of so much work. I would think of all sorts of reasons why eight hours, or maybe less, was really a fairer estimate of "according to my abilities." This attitude would not be reprehensible on my part; it is a natural human response. It is reasonable to give openendedly of one's own time and effort as long as one is in control of the decision to make that level of effort. To open oneself up to a *demand* that one put out that much effort is foolish. I must preserve some part of myself from open-ended demands by society, and the only way to do so is to restrict my internal view of what I am capable of contributing to society.

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Unfortunately, the result is to cripple my capabilities. Our expectations of ourselves are intimately related to our achievements, and the open-ended moral demands of socialism constantly lead people to minimize those internal expectations.

A comparable dynamic will work with regard to my definition of "to each according to his needs." The ideal calls on ordinary people to be saints. Worse than that, it seduces virtuous people into behaving greedily. I will use a simple example to illustrate these points. Let us assume I am a person who is supposed to live by the ideal of "to each according to his needs" regarding needs for food. From a purely nutritional point of view, I can be healthy on a simple diet of grains and vegetables. But if I define that as my needs, and my neighbor defines his needs as consisting of meat as well, what am I to do? Obviously, I must be extremely suspicious of my neighbor. We are supposed to be using the same moral calculus, defining our own needs reasonably. So how is it that he needs meat and I do not? Either I have been wrong in defining my needs (and must expand my definition) or he is wrong in defining his needs (and should be forced to restrict his definition). Note that this competitiveness exists even if I am a vegetarian and do not like meat. The question is not whether my neighbor and I both *like* meat (he does, I do not), but whether either of us *needs* meat, and if I do not need it for good health, why should he? If, nonetheless, meat is available, what is the reasonable course of action for me to pursue? Obviously, I should avail myself of the meat—get my "fair share"—and then try to sell it to someone else. The only way that I will refuse the meat that society is doling out is if I am extraordinarily selfless.

Who Cares about These Ideals Anyway?

The preceding discussion may seem to my Soviet readers to be unrealistically idealistic in itself. I can almost hear some of my readers thinking: It has been decades since anyone really believed in "from each according to his abilities, to each according to his needs" or in egalitarianism. I will grant that point, to some extent. But one should not underestimate the effects of ideals on one's internal outlook. I agree with Adam Smith's argument in *The Theory of Moral Sentiments* ([1759] 1976) that part of human nature is to want moral approbation. We feel an underlying loyalty to the ideals we have been taught from childhood, no matter how dishonored the ideals are in practice. When those ideals are at war with other aspects of human nature—as I believe the ideals of socialism are at war with other aspects of human nature—the internal tensions are great, and the damage done to the human spirit is great as well.

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But Are the Ideals not Still Worthy?

Another response to the foregoing discussion might be that the ideals themselves are worthy, even if they have not worked out very well in practice. Indeed, it may be said that the ideals of socialism are superior to those of capitalism. Socialism at least aspires that human beings be altruistic, or committed to the welfare of others. For capitalists, everything is self-interest and greed. Here, we come to a curious paradox: The ideal of human behavior that people hold for the human race in the abstract is often at odds with the kind of human being they prefer in practice.

We in the West as well as those in Eastern Europe and the Soviet Union tend to think of the best kind of human being, the one who exemplifies human goodness and virtue, as being one who puts the welfare of others above personal welfare. Such people spend their life doing good works for others. I too find such people to be admirable, in their place. But when it comes to our day-to-day lives, our priorities for human virtue are usually different. The reader may put this statement to the test through the following thought experiment.

First, think of the people who figure in your own life. This large, heterogeneous group presumably comprises people ranging from spouse and children, to close friends, to coworkers, to acquaintances and the salesperson who sells you a loaf of bread at the market. Some of these people enrich your life; some of them are neutral; some of them detract from your life. Contemplate for a moment the differences among these people. What do the ones who enrich your life have in common? What do the people who detract from your life have in common? What is it that they *do* that makes them enriching or detracting? I will offer my answer, and you may decide whether it is consistent with yours.

The people who enrich my life are those whom I can count on to deal fairly with me, to tell me the truth, and to keep their promises. Each of these people does more—my friends are sympathetic listeners, or humorous, or have some other quality that makes me enjoy their company—but honesty and integrity are essential ingredients. It is impossible that they be truly valued, truly enriching, without those qualities. When I think of the ways in which acquaintances or strangers enrich my life (the salesperson, for example), I have much the same answer: They deal fairly with me on the basis of mutual consideration and are courteous or perhaps more than that, but they are never intrusive. My closest friends will try to help me if I have a problem that requires help, but they do not involve themselves in my affairs without being invited. They respect my privacy and my

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competence, and they would consider it wrong to do something "on my behalf" without making sure that I wanted them to do it. These things together constitute "human goodness" as it affects my daily life.

The people who detract from my life are people who do not possess these same characteristics: people who do not deal with me honestly; who cannot be relied on to keep agreements; who purport to be my friends but, in fact, behave in an unfriendly way; or who are acquaintances who behave rudely. These people would be no better, in my opinion, if they were busily engaged in trying to do things on my behalf. I would resent their doing so. Whereas I have often gratefully accepted help from my friends, it would be demeaning to my self-respect to be obligated to a person whom I thought to be dishonest, untrustworthy, or unpleasant.

In sum: When I compare the public understanding of human goodness (social commitment and unselfishness) with my day-to-day understanding of human goodness, the relationship of the two understandings is extremely tenuous. For those readers whose answer is similar to mine, this question comes to mind: Why should the public understanding of human goodness be so different from the private understanding? Why not use the private understanding as the basis for organizing a society in which people can best pursue happiness? And that understanding leads us to consider an alternative to socialism.

The Pursuit of Satisfying Human Relationships under Limited Government

The title of this paper promises a contrast between socialism and capitalism. As the heading for this section indicates, I have suddenly switched terminology. This change from "capitalism" to "a limited government" warrants a few words of explanation.

"Capitalism" and "socialism" are both labels for economic systems. The difference is that they have different levels of implication for a political system. In a socialist economy, the political options are highly constrained. Socialism, of necessity, means a strong central government that has sweeping powers over the behavior of individuals. To take just one example of this inherent necessity, we see that a socialist system must severely restrict the freedom of individuals to engage in contracts and economic transactions. It must also necessarily establish large and powerful police institutions to enforce the restrictions.

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In contrast, a capitalist economic system can exist side-by-side with many different kinds of political systems and ideological stances. Sweden has a capitalist economy, though it is the most complete welfare state in the West and is stridently egalitarian in its ideology. Chile has a capitalist economy, even though it is an authoritarian state. Capitalism does not necessarily mean the kind of political system that I am recommending; therefore, I have changed the terminology.

Specifically, I am presenting a case for "limited government," the kind of state that is sometimes called "Jeffersonian," after Thomas Jefferson, author of the Declaration of Independence and third president of the United States. This is how he described what he called "the sum of good government" in his inaugural speech as he assumed the office of president in 1801: "A wise and frugal government, which shall restrain men from injuring one another, which shall leave them otherwise free to regulate their own pursuits of industry and improvement" (Peterson 1975, p. 293).

To elaborate: Such a government has an indispensable role as an impartial referee. It enforces laws that prohibit one person from physical aggression against another—from murder, assault, robbery, trespass, and the like—and enforces the terms of private contracts. A second function is to protect private property from expropriation by any person or any institution. And a third function is for the government to engage in a few activities that meet a strict definition of "public good," such as building roads and financing education. In other words, I am advancing the views of a 19th-century Whig, more commonly known these days as a "classical liberal," whose intellectual forebears are Adam Smith and John Locke and whose most prominent modern-day exponents are Friedrich Hayek, Milton Friedman, and James Buchanan.

Socialist rhetoric says that I must, therefore, be a merciless individualist. "Have the government enforce a few basic rules," I seem to be saying, "and then let everybody fight it out, with the strong getting rich and the weak being pushed into the gutter." My central purpose in this paper is to suggest that this view is radically mistaken. Let me distinguish between two issues. Limited government *permits* people to live as isolated individuals, but the way limited government works in practice militates against that brand of individualism. In practice, limited government facilitates—virtually forces—a society to generate complex, rich, and rewarding personal relationships that are based on cooperation and mutual help. Now let me try to explain why.

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Little Platoons

One of the most common, but also most wrong-headed, ideas about classical liberalism is that it stands in opposition to the development of strongly bound communities. There is certainly an element of individualism in classical liberalism, in the sense that each human being is an end in himself or herself. Freedom, dignity, virtue, and justice all must be defined in terms of the individual. But this definition does not mean that classical liberalism envisions people living their lives on separate mountain tops. Precisely the opposite is true. Let me repeat the point made earlier: People pursue happiness by actions, and these actions are usually social. Human beings have needs as individuals that cannot be met except by cooperation with other human beings. To this degree, the often-lamented conflict between individualism and community is misleading. The pursuit of individual happiness cannot be an atomistic process; it will naturally and always occur in communities. The state's role in enabling its citizens to pursue happiness depends ultimately on nurturing *not* individuals, but the associations they form.

The basis for my discussion is this famous quotation from the English political philosopher, Edmund Burke (1960, p. 44):

> To be attached to the subdivision, to love the little platoon we belong to in society, is the first principle of public affection. It is the first link in the series by which we proceed towards a love to our country, and to mankind.

I am using the image of the little platoon to represent the essential relationship of a social organization to the pursuit of happiness and, by extension, the relationship of the state's social policy to the pursuit of happiness. We each belong to a few little platoons. The great joys and sorrows, satisfactions and preoccupations, of our daily life are defined in terms of them. This observation, I will assert, applies to everyone, rich and poor, famous and obscure, citizens of Moscow or of Washington.

Using a central government to enable people to pursue happiness becomes in this perspective a process of making sure that the little platoons work. The little platoons of work, family, and community are the nexus within which intimate, rewarding human relationships are worked out. That being the case, "good" government can be defined only after we have answered the questions: How do little platoons form? How are they sustained? What makes them nourishing?

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Affiliation as the Mechanism for Forming Little Platoons

The key concept in this discussion is "affiliation," the label I will give to the process whereby intimate human relationships are formed. I quote Edmund Burke ([1796] 1967) again: "Men are not tied to one another by papers and seals. They are led to associate by resemblances, by conformities, by sympathies."

An affiliation behavior may be one whereby one person forms new relationships with others. It may consist of an effort to alter an existing environment. Sometimes it may mean leaving relationships that are unsatisfactory. But the word "affiliation" probably evokes too many of the formal types of affiliation—joining a club, getting married or divorced, serving on a committee—and not enough of the small acts of affiliation that make up the larger ones. The places you shop, the friends you choose, the relationships you have with coworkers, the ways you spend your leisure time—all bespeak and define affiliations.

Affiliation behaviors, as I am using the term, are not contractual. Near my old home in Washington, D.C., was a favorite delicatessen—a little store selling sandwiches, pastries, and a few groceries. The prices were not always the best I could find, but I liked the place for many little reasons. I could joke with the people behind the counter. They recognized my children when they came in. They let me buy a sandwich on credit if I had forgotten my wallet. And the food was pretty good. Technically, what I was doing could be construed and analyzed as a series of market decisions about where to shop (just as affiliations in the aggregate bear many similarities to the way that free markets work, through analogous dynamics). But in reality, the formation and sustenance of my affiliation with the delicatessen was much closer in its characteristics to the way that friendships form and are sustained.

I use this simple example to emphasize that people very rarely wake up one morning and decide to form a particular affiliation. They only rarely decide all at once to leave affiliations. Most commonly, interactions embraced under the heading of affiliation are small steps (taken for reasons having nothing to do with any conscious interest in forming affiliations) that have cumulative effects over time. As people go about their daily life, affiliation behaviors occur.

A second important point about affiliations is that they do not have to exist. It is possible to live in a neighborhood, isolated and alone, and have no affiliations. It is possible to treat a job as a purely contractual relationship ("I agree to be at this place, doing these

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tasks, for this many hours per week, for this amount of money"), devoid of affiliations. Affiliations may be many or few, strong or weak, rich or unfulfilling. One chief determinant of their existence and their nature is the extent to which they are used to live out beliefs.

The affiliation involving the delicatessen is one of many that make up my larger affiliation with a neighborhood, which in turn is one component of the affiliations that constitute my still larger affiliation with a community. Trivial as it is, the affiliation with the delicatessen illustrates a feature of affiliations that has tended to be lost. People affiliate with others because of *something about* other people—in the case of the delicatessen, the qualities of being friendly, helpful, and amusing.

My point may seem a distinction too obvious to mention. Of course one is attracted to something about someone else, since there is no such thing as being attracted to someone as an abstract entity. But however obvious, the distinction is essential to our understanding why little platoons are rewarding or unrewarding, why they sustain themselves or fall apart: *Affiliation is a means whereby people of common values are enabled to live by those values.* "Values" in this case means your views about how the world works or ought to work, ranging from child-rearing, to politics, to table manners, to religion, to standards of public civility.

The reason affiliation is so intimately linked to limited government is that only under the Jeffersonian conception of freedom can people make the hundreds of small choices that lead to affiliations. Let us examine one feature of limited government: a private housing market. In that market, people do not shop for houses as much as they shop for an environment. In the Washington, D.C., area are literally dozens of different kinds of neighborhoods. Even within a single price bracket, the choices range from impersonal high-rise apartment buildings in the middle of the city to detached houses in a rural setting, and all the variations in between. Some neighborhoods are dominated by families with children, some by elderly people, and some by single people looking for a good time in the big city. I could take you to neighborhoods that consist mostly of Democrats and others that consist mostly of Republicans; ones that feature a high proportion of homosexuals or lobbyists or military personnel or journalists; ones that are all-white, all-black, or a polyglot mixture of white, black, Vietnamese, and Hispanic. This is not to say that the neighborhoods are formally compartmentalized from each other, nor that affiliation decisions are as simple as saying, "I want to live in a neighborhood where everyone is a Democrat." Rather, one seeks out an environment in which one is comfortable.

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Soviet readers may ask whether this happy state of affairs also applies to low-income people. If one refers to working-class families, the answer is generally yes. Within 10 miles of the White House, I could take you to a wide variety of working-class neighborhoods, black and white and mixed. But if we are talking about the poorest segments of society, the answer is generally no, and the reason is worth considering for a moment. The reason that poor people in urban America now have little choice of neighborhoods is not because the people are poor. Historically, poor people, like the middle class, have lived in many different kinds of neighborhoods, some dirty and crime-ridden, others as neat and safe and civilized as any middle-class neighborhood. But during the past 30 years, the United States has cut away the private housing market in poor neighborhoods, with widespread public housing and rent control and a multitude of regulations. As a result, affiliations through housing choices have become almost as difficult for poor people in urban America as they are in a socialist country with a central housing authority. The results have been disastrous.

Let us return to the main point: A free housing market represents just one way in which private property and the freedom to choose enable people to live their lives among people who share their values. If you are to live according to many of your most important beliefs, it is essential that you be free to affiliate with fellow-believers and that, together, you enjoy some control over that environment. Limited government leaves a huge variety of decisions and controls in the hands of individuals, and they use those decisions and controls to nudge themselves, often in small incremental steps, toward environments that they find congenial. The Austrian economist Friedrich Hayek is famous for his discussion of the ways in which complicated knowledge, held by thousands or even millions of individuals, creates prices for goods that are efficient and appropriate. I am arguing along similar lines that the hundreds of ways in which people can exercise control over their lives, by decisions as simple as deciding which store to patronize, set up desirable arrangements whereby people are led into cooperative social relationships. In part, people are finding other people with whom they are sympathetic. In part, the natural social pressures generated by people living under limited government induce attractive interpersonal relationships. There is nothing mysterious about it. If I choose a neighborhood where I want to be accepted, I had better behave in ways that will encourage my neighbors to like me. Or we can return to the even simpler example of the delicatessen: If I rely on you to shop at my store of your own free choice, I had better be pleasant to you and give you good value.

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If you question whether this approach works in practice, the United States offers an excellent natural laboratory with a wide range of outcomes. In the past 30 years, the U.S. government has enacted laws that systematically restrain free affiliation. The intent of these laws is admirable. Their purpose is to overcome irrational discrimination, especially according to race but also according to gender, sexual preference, age, and physical handicap. Unfortunately, in trying to accomplish this admirable purpose, the government put severe restrictions on free affiliation in housing, employment, education, social services, and a variety of business activities.

The reason the United States offers an excellent natural laboratory is that these government actions have affected some communities more than others. Large cities have been affected more than small towns; poor communities have been affected more than middle-class communities; states with a large black population have been affected more than states that have small black populations. I offer this generalization: Traveling around the United States you will find the courteous, harmonious, socially effective human relationships I have described in those communities that have been least affected by government intervention. If you will permit a little boasting, Americans in such communities are extraordinarily friendly and helpful, to each other and to strangers as well. By the same token, you will find the most tense, hostile, and ineffective human relationships in communities that have been most drastically affected by the government's attempts to engineer human interactions. Government restrictions on affiliation are destructive not only under socialism, but under democratic capitalism as well.

Creating Rich Affiliations

In the everyday world some affiliations work much better than others. Some marriages are richer affiliations than others, some neighborhoods are much more closely knit than others, and so on. Even a commonality of beliefs is obviously not enough—some local churches and social organizations are much more vital than others. The question, therefore, becomes not only how affiliation occurs, but also how it becomes infused with satisfying content, to which I now turn.

Put aside the concept of affiliation for a moment and consider the things in which you take satisfaction and why. If possible, focus on some specific achievement in your life—in your work, your family life, whatever—that stands out in your mind as something in which you take satisfaction. I suggest that you take satisfaction because of

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three factors: the degree of *effort* you put into it, the degree of *control* you had over the outcome, and the *importance of the function* it serves.

The importance of effort is perhaps self-evident—try to think of something from which you take great satisfaction (not just momentary pleasure) that involved no effort on your part. I need not belabor this. Many American aphorisms make the same point: "Nothing worth having comes easy." or "You take out of something what you put into it." Life everywhere, under every system, involves things that require a great deal of effort. But without the other two factors, control and function, effort alone can be brutally tiring, boring, and unsatisfying.

Some degree of control is the next crucial ingredient of satisfaction. It is essential to have a sense that one is choosing among options and is not being forced willy-nilly into channels chosen by others. Take a simple example: If I earn money and take it to a store that I choose, to buy what I want, there is more satisfaction than if I earn the same amount of money, am forced to shop at the only store that the authorities permit, and am forced to buy what the authorities decide to put on the shelves. I argue that satisfaction is diminished by his lack of control—even if I end up with the same item I would have gotten on my own. The exercise of the power of choice is often as important as the things chosen.

The third factor that goes into the production of satisfaction is the importance of the function being served. Generally speaking, functions can be arrayed on a continuum in importance from trivial (such as passing the time) to profound (such as saving someone's life). In the absence of some highly unusual circumstances, I am arguing, it is not as satisfying to spend a great deal of effort to have great control over a trivial function as it is to spend the same amount of effort to have great control over a profoundly important function.

The point I wish to stress is that the same conditions that shape individual satisfactions apply to the satisfactions gained from affiliations. The affiliation called "friendship" is decisively affected by the context within which the friendship exists—witness the deep bonds between comrades in war, for example. The affiliations that make up a community are much richer if they express themselves in important tasks rather than in trivial ones. Or if we put it in terms of the little platoons through which we work out the pursuit of happiness: To exist and to be vital, little platoons must have important functions to fill.

Let me now begin to put these considerations alongside the proposition that limited government facilitates these kinds of rich human

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relationships. Forget for a moment about socialism as a specific type of system and consider it as just an extreme version of what has been happening throughout the industrialized world, socialist and capitalist alike: Throughout the 20th century, governments, including the U.S. government, have been taking control over the stuff of life away from the individual, from the family, and from the community.

Imagine for a moment a married couple living at the beginning of the 20th century. I will use a couple in the United States as my example, and Soviet readers can make adjustments for the situation in pre-revolutionary Russia. Consider the components of the "stuff of life" for my imaginary couple. The couple had direct responsibility for finding a place to live, getting enough food to eat, raising their children (including deep involvement in their education), providing for hard times and old age, and perhaps caring for elderly parents. They also had to find and hold down a job that was a means both of staying alive and of establishing their place in the community. It was within the community, with hardly any help even from the state government, let alone the national government, that the sick had to be cared for, widows helped, orphans sheltered, order preserved, malefactors punished, and bereaved comforted.

Imagine a similar couple and community in 1990. In the United States, the national government has removed some degree of responsibility and control of each of these functions from the couple and from the community. The process has gone much further in Western Europe. In the Soviet Union, the process was supposed to be complete, so that all of the important functions of life were to be planned, financed, and controlled by a central authority.

This is progress, many would argue. Life was too difficult before. It is better to have the government help out. I will not argue that point except to say briefly that I disagree. In my view, the improvements that America has enjoyed since the beginning of the 20th century occurred because of increases in wealth and an explosion of technology that would have had even greater positive effects if government had remained limited. But that is a very ambitious argument. Thus, my more limited argument will be that the problem with such reforms, apart from anything having to do with their immediate effects, is that when the individual and the community lose control and responsibility for these fundamental building blocks of life, there is a corresponding diminution in the potential satisfaction that might be obtained from the activity that has been affected.

My argument is that even if there were some positive benefits from socialism, there are still the negative side effects of diminishing

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individual responsibility and removing the "glue" that holds communities together. I propose, in short, that there is nothing mysterious about why people become atomized under socialist systems. Affiliations, whether or not they tie together communities or families, are rich and strong and satisfying in direct proportion to the functional value of those affiliations. As people attach themselves to these complex relationships, the aggregate intangibles called "community" and "family" take on a life of their own that is greater than the sum of the parts. Take away the functions, and you take away the purposes of community and family. The cause of the problem is not a virus associated with modernity; it is a centralization of functions that should not be centralized. This centralization is very much a matter of political choice, not ineluctable forces.

Conclusion

People living in capitalist societies are still better able to pursue happiness in the ways I am describing than are people living under socialism. Despite the inroads made by the welfare state in Western Europe and North America, people in those parts of the world continue to have much more control over important functions of their lives than do people living under socialism. I think the merits of the capitalist model are revealed by an examination of the quality of personal and community life in the countries of the West versus the socialist countries.

But I am far from satisfied with the current state of affairs in the West. And I will not argue with readers who have traveled in the West and tell me that they have seen evidence of depressing atomization and alienation in New York City, whether they are referring to the homeless or to rude taxi drivers. The United States and the countries of Western Europe have been moving in the wrong direction in recent decades, and the damage has been substantial.

I am asking that the Soviet Union look for inspiration not to the contemporary West, but to the West of two centuries earlier. It is not necessary that you adopt the American founding fathers as your mentors, brilliant through I believe they were. Perhaps better choices for the Soviet Union are those two wise Englishmen, Burke and Smith. Edmund Burke recognized the unarticulated wisdom of tradition and of culture. Surely no restructuring of the Soviet Union can be wise that does not remain true to the best in the ancient Russian heritage. Adam Smith saw the possibilities of men and women as social beings, freed from the shackles of government while

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protected from aggression by their fellow citizens. Surely reforms in the Soviet Union must also liberate its people in this way.

Perhaps Burke and Smith gave us their wisdom prematurely. Perhaps the world had to go through the trauma of industrialization and of urbanization, and for a time had to conclude that resources were too scarce and humans too divided to live freely together. But that time is drawing to a close. As affluence spreads throughout the world and as technology destroys barriers that once seemed insurmountable, it is time to reconsider Thomas Jefferson's vision of a government that "shall restrain men from injuring one another, which shall leave them otherwise free to regulate their own pursuits." It is time to contemplate the possibility that his vision was applicable not only to a struggling America at the opening of the 19th century, but also to a world full of the promise of new beginnings at the close of the 20th century.

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Obstacles in the Pursuit of Happiness

Otto Latsis

Charles Murray worries that the theme he has chosen for his study is impractical, is subjective, and bears little relation to the realities of the Soviet Union in 1990. Such worries can be cast aside without hesitation. Yes, Soviet life today is filled with day-to-day economic and political concerns of a purely practical nature. But interest in such abstract questions as the characteristics of different social systems, the principles of socialism and its differences from capitalism, and so forth has never been higher than today.

There is nothing surprising about such a state of mind. We have found that the multitude of everyday discomforts that besiege us are by no means merely the result of errors in current management of social production but of deeper causes rooted in the features of the social system itself. Moreover, the errors in current economic and political practices are themselves inextricably linked to the system's general features.

Thus, clarifying the principal questions of the theory of social systems and social development assumes the nature of a quest for practical instruments to overcome specific, real-life difficulties.

Along with this pragmatic interest is another factor that stimulates public attention in such abstract problems: the age-old tradition of Russian thought. As the Russian philosopher Nikolai Berdyaev (1990, p. 9) pointed out, the Russian people and the Russian intelligentsia are prone to the quest for a kingdom built upon truth. Entire generations, for the most part, believed that socialism was such a kingdom. Today, this faith has been shaken. Now people are feverishly reassessing their notions, wishing either to find new evidence to support

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the familiar faith or to become absolutely convinced of its invalidity and to find some new truth.

Charles Murray formulates his central thesis as follows:

> The ultimate reason to adopt a system of limited government that protects a free market and private property is not to increase economic production. The ultimate reason is that such a system better enables its citizens to live together harmoniously and to fulfill their potential as human beings—in short, to pursue happiness. Centralized governments in general, and socialist governments in particular, inherently impede these goals.

I agree with the first two sentences cited above; I hope to be able to counter the thought expressed in the third.

The Dream of Justice and the Socialist Idea

More than 100 years ago, Leo Tolstoy wrote his *Russian Readers*. In them, he collected moral fables, fairy tales, and stories for the people. The novelist hoped that generations of Russian children would be reared on these books. The best stories are, indeed, still included in textbooks for schoolchildren. And just what notions of happiness did this great writer seek to inculcate?

One key story by Tolstoy is a tale called "A Grain as Big as a Chicken Egg."[1] It expresses the dream of a just life that ensures human harmony with nature, moral and physical health, and longevity. What are the secrets of this happiness? Absence of money, trade, and property. The old peasant says to the Tsar:

> In my time, no one could even think of such a sin as selling or buying bread. As for money, no one even knew of such a thing: everyone had enough bread of his own. . . . My field was God's land. Wherever you ploughed, that's where the field was. The land was free then. No one could call a piece of land his own; only your labor was yours.

This is how Tolstoy's hero explains the fall of the high morality of old:

> All of this happened because people no longer lived by their labor; they began to set their eyes on what other people had. That's not how they lived in the old times; in the old times people lived in a godly way: they had what was theirs, and did not covet what was someone else's.

The other tales and stories preach reasonable self-restraint, limited consumption, and modest wants. Tolstoy had studied history in

[1]See Tolstoy's *Collected Works* (1978).

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depth; he knew very well that the beautiful past he was describing had never existed. The tales convey the dream of a just life that is typical of the patriarchal peasantry, which was bewildered and frightened at the turn of the century by the onslaught of capitalist ways on the communal traditions of the Russian village.

The dream of a world of equal justice, equal division of labor and goods—a world where no one has too much or too little—is surely a universal human dream. These ideas were certainly not originated by Marxists. The idea that "money is the root of all evil" can be found not only in Tolstoy but also in Shakespeare. And projects for a just, rational world order were developed centuries ago by Sir Thomas More and Campanella.

However, even in the 19th century, after Robert Owen's notorious experiments, it became clear that the problem of universal happiness could not be solved so easily. Attempts to organize communes with a fair division of labor and egalitarian distribution of goods (not based on capital or labor) continue to this day. But, for one thing, communes have not gained much of a following. Also, they are not being undertaken by Marxists or in socialist countries. Thus, an article in the Soviet press, "They Choose the Commune" (1990), recently described the Glenn Ivy commune near Los Angeles in the United States. It has branches in England, France, Canada, and South Africa—but not a single branch in any socialist country.

What, then, is the Marxist, scientific socialist approach to this problem? To answer this question, let us begin by comparing the statements. The first statement is "The reality is that people are *not* equal. They are not equal in tastes, talents, aspirations, industriousness, kindness, or any other human quality." And the second is "Yet individual people are not equal; some are stronger and some weaker, some are married and some are not, some have more children and some have fewer, and so on."

These statements sound very much alike. The idea is definitely the same, and even the wording is quite similar. The first was written in 1990. It comes from Charles Murray's paper on which I am commenting. The second was written in 1917; it is an extract from Lenin's book, *State and Revolution*. Lenin, in turn, is not expressing his own idea but is only summarizing the theses of the *Critique of the Gotha Program*, written by Marx in 1875.[2]

Murray is wrong in believing that he is refuting Marxist scientific socialism. On the contrary, in this particular thesis he backs Marxist notions. It is true that his consequent conclusions differ from Marxist

[2]See Somerville and Santoni (1963, pp. 414–15)—ED.

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ones. Marx concluded from his affirmation of human differences that true equality, given the contemporary level of production capacities, was altogether impossible. The ideal of equality, he believed, could be reached only under completely different conditions, in an unforeseeably distant future.

Thus, I have no objections to Murray's critique of the egalitarian ideal. I agree with this critique. His mistake is to attribute these ideals to Marxian socialism. In reality, Marxism is just as critical of leveling ideas.

A Marxist formalist could have stopped at this point: Murray has been "caught" vulgarizing Marxism, while, in fact, our founders were not so stupid and did not share such simplistic notions.

Unfortunately, I cannot leave it at that. We know that political life does not always develop according to political books. It is true that leveling notions were rejected in the scientific works of Marx and Lenin. But it is also true that these vulgarized notions were often carried out in the political practices of their followers; in some places, these practices still go on. Our dogmatists have a simple answer: It is not the fault of the idea; it is the fault of people who executed it badly. But, actually, such an answer contradicts Marxism. If a theory is not borne out by practice, we should ask whether the theory was right.

What It Was We Were Building

First of all, however, we should clarify exactly what theory we are speaking about. Is any theory socialist that calls itself such?

In 1853, Friedrich Engels wrote:

> I have a feeling that one fine day, our party will be forced by the helplessness and sluggishness of all other parties to assume power so as, ultimately, to carry out things that do not specifically correspond to our interests but to general revolutionary and specific petty bourgeois interests. In this case, under the pressure of proletarian masses, bound by our own printed declarations and plans, to a certain degree misinterpreted and set forth in the heat of partisan struggle, we will have to conduct communistic experiments and make leaps we perfectly know ourselves to be most untimely. In the midst of all this, we are going to lose our heads—only, one hopes, in the physical sense. [Then] the reaction will set in, and before the world can evaluate these events from a *historical* point of view, we shall be considered not only monsters, which is all the same to us, but also fools, which is far worse.[3]

[3]In Marx and Engels, *Collected Works*, vol. 28, pp. 490–91.

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The danger to a revolutionary proletarian party that Engels foresaw was the necessity of ill-timed action in a backward country. This danger was avoided by the German Communists of the mid-19th century, only to strike Russia a few decades later. At the start of the second decade of the 20th century, our country was already groping for an evolutionary, reformist road from patriarchal semifeudalism to a civilized, democratic, industrialized society. But World War I made the peaceful road impossible. In the face of the tremendous social and political upheavals it brought forth, the tender shoots of a democratic political culture proved immensely weak. Instead of evolution came revolution, the road of greatest sacrifices.

The class coloring of all social development changed drastically. It seemed that its goals had suddenly become different. That was (and, often, still is) the view of both opponents and supporters of the revolution at home, as well as that of outside observers. Meanwhile, certain patterns of development common to all of civilization take their course no matter what the sociopolitical system or the ruling party. Russia faced the same tasks of industrial development that the United States and Western Europe had already solved in their own ways. No country escapes industrialization, with its related processes of urbanization and cultural revolution, even though every society goes through those processes in its own unique way.

The special historical conditions that had taken shape in the Soviet Union influenced both the pace of developing an industrial society and its essential features. Industrialization was sped up drastically; at the same time, many distortions were imposed on the emerging society. The most obvious manifestation of these distortions was rampant lawlessness, the loss of great numbers of lives. There was also something less obvious: the tendency toward extreme ideologization, a sort of canonization of everything that happened in Soviet history. Everything we did was proclaimed the best in the world, was unprecedented, and was uniquely right and due only to our social system—socialism—and to our social philosophy—Marxism-Leninism. Until the mid-1950s, one also had to add: . . . and to our leader Joseph Stalin. This latter part was eventually discarded, but the rest remained for a long time.

Our economic system of planning and distribution was no exception: It, too, was entirely and completely identified with socialism. Socialism equals the plan; capitalism equals the market. The socialist system is centralized; the capitalist system is free. That is how most Western observers see things, and that is what Charles Murray says too. This view is hardly surprising: Such notions were fostered for decades by Soviet political economy, whose dogmas were created at

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the personal instructions of Stalin. What is far more surprising is that some Soviet economists, too, still share these views, when even our government is learning to look more soberly at the laws of economics.

Neither planning and centralization on one side nor markets and free competition on the other are rigidly tied to one or another social system, be it capitalism, socialism, or something else. World history's first model of a planned/distributive system did not arise in Soviet Russia but in Germany during World War I, when not a single socialist state was yet in existence. Experience has shown that such an economic model provides the best way to solve the specific tasks of industrial management in wartime, whether in a capitalist or a socialist country.

In our country, the planned/distributive system in its most extreme manifestation—"war communism"—was used in civil war conditions in 1918–1920 and was replaced in 1921 by a market system: the New Economic Policy (NEP). When, in 1929, Stalin smashed NEP, he committed violence against the objective requirements of economic development; the inevitable penalties for this destruction were economic losses and human casualties. However, Stalin found a certain amount of justification in the needs of accelerated industrialization and preparations for the country's defense. Then, World War II again created objective circumstances to which this system was entirely well suited. However, its preservation after the end of the war was undoubtedly a mistake that drastically reduced the efficiency of economic development.

Today, this economic system has outlived itself in the Soviet Union by about 40 years, but its days finally seem to be numbered. Its collapse is not the collapse of socialism but of the administrative centralized system, imposed in conditions where there were no objective factors to justify that system. Shall we be able to use the market system under socialism? That is something we will find out in the nearest future.

Socialism and the Pursuit of Happiness

Stalinist dogma gave an extremely rigid, harshly outlined definition of socialism. Among the absolutely unquestionable requirements were public (primarily state) ownership of the means of production; a centralized, planned economy with no recognition of market relations; a one-party political system with the constitutionally guaranteed power of the Communist party; rejection of the rule of law; fusion of legislative and executive powers; and dominance of Marxist-Leninist ideology.

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Today, in our legislation and our practice, we have adopted as our premises the recognition of the equality of state, cooperative, private, and other forms of ownership. We intend to create a market economy that is subject only to indirect (economic) regulation. We have rejected the one-party system and the authoritarian power of the Communist party. We are working toward the separation of legislative, executive, and judicial powers and toward the rule of law. And we have recognized ideological pluralism. Since, at the same time, most Soviet people have no intention of rejecting the idea of socialism, we have to admit that so far, we have not had a very good understanding of what socialism is.

For us, the redefinition of socialism has become an immediate and urgent task of scholarship and political practice. It seems to me that many of Murray's points are undoubtedly helpful in this task. I consider much of his criticism of egalitarianism and many of his remarks about practical flaws in our society's functioning to be fair. However, I would link those flaws not to socialism as such but to the specific kind of socialism that has been achieved in Soviet society so far.

I also accept the theory of limited government. And I do not have any quarrel with the definition of happiness offered in Murray's paper: an individual's long-term, justified satisfaction with his life as a whole. His reflections on the different types of interpersonal affiliations and, in particular, on the psychology of so-called little platoons are quite interesting. But it seems to me that this type of affiliation should not be promoted to the rank of absolute or represented as the sole effective kind.

The stability of small groups is a phenomenon long noted by social psychologists. This type of interpersonal connection has always been characteristic of Soviet life as well; in recent decades, apparently, its role relative to other types of relations seems to be increasing. However, I believe it would be too one-sided to claim that affiliations within a small group are essential to human happiness, but affiliations, let us say, within society as a whole are not. I think that under any social system both the material well-being and the spiritual fulfillment of individuals depend on affiliation with a family, with one or several small and large collectives (professional, athletic, cultural, or political), and on belonging to a national community.

And, in extreme conditions, which have been so common in the 20th century, when the independence or even the survival of a nation is threatened, the importance of national ties can even become the top priority, as we know from the experience of our country too.

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What I find exceptionally interesting are Murray's remarks about the error of social policies designed to "take the trouble out of life." I think that many if not most people, not only in socialist but even in capitalist countries, will disagree. Yet it seems to me that on this point, Murray is mostly right.

Actually, I do not find his chief argument—the point that people do not derive full satisfaction from benefits obtained without effort—very persuasive. I think there are weightier reasons not to "take the trouble out of life."

First, we have seen the economic inefficiency of social policies under which an individual does not have to be responsible for his own housing, education, or health care. The arbitrary removal of vast spheres of economic life from the turnover of commodities has distorted economic life as a whole, made it impossible to guarantee a stable ruble, and heightened inflation.

Second, such a policy has proved very ineffective in its social consequences. Intentionally or not, we have created a state of affairs in which an individual not only does not have to take care of, let us say, finding a home, but cannot take care of it even if he wants to. As a result, quite often he ends up not getting any housing or getting very poor-quality housing with not enough space. Or he spends years on a waiting list. Here, the danger of discontent—because a certain good has been obtained too easily—recedes into the background. Far more painful and sometimes tragic is discontent because a vitally needed good has not been obtained at all.

Finally, I would like to point out the most general reason that "taking the trouble out of life" is not a good idea. That reason is the danger of a certain degradation of skills, of the atrophy of unused abilities. When life requires no special effort, a person loses or never learns certain vital skills. If certain abilities—of will power, intellect, or physical strength—are not used, they never develop.

According to Marxist views, to enable the versatile growth of the human personality is the most important goal and the distinctive characteristic of socialism. On the basis of this premise, our society has tried, though not always successfully, to create the conditions for multifaceted personal growth. But while attending to the conditions, we did not give much thought to the incentives that move an individual to take advantage of these conditions.

Indeed, there were counter-incentives. The system of basic social gaurantees ensures the ability to survive at the level of a social minimum that satisfies basic needs, without much effort to develop one's work skills, education, or general level of culture; one does not even have to work very hard.

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At the same time, even if one takes great efforts to improve one's skills and productivity, it is often very difficult to rise high above the same social minimum, above the satisfaction of one's most basic needs. In other words, outstanding abilities, high skills, and extra-hard work do not bring adequate material or moral rewards. If, in Pushkin's famous fairy tale for children, the Dolt "eats the meals of four, does the work of seven," the manager of a modern Soviet enterprise would have had a hard time giving even "the pay of two" to a worker doing "the work of seven." And even if he had been able to reward an exceptional worker adequately, he would have incurred the displeasure of other workers. Widespread egalitarian notions that regard high earnings as immoral are the biggest obstacle in our way to a market economy today.

Nonetheless, I think that this obstacle, inherited from the Stalinist past, is a surmountable one. Of course, to surmount it will require not just educational or, as we have a habit of saying, "explanatory work." Guarantees of a certain minimum of social conditions will be required as well. The policy of "keeping the trouble in things," just like the policy of "taking the trouble out of things," should not be taken to its extreme. I think that two kinds of social guarantees are justified. One is a set of guarantees in the areas of education and health care, providing, as much as possible, equal opportunities for every member of society to get started in life. The second is guaranteed employment for everyone who is willing to work conscientiously.

Conclusion

These comments, willy-nilly, have been sketchy, because I have had to cover a very broad range of issues in a brief text. This sketchiness may create the impression that our notions of socialism today are vague and even elusive. However, such is not the case. The renewed conception of socialism has not been developed fully, but its basic principles are known; they do not contradict the Marxist tradition but are a development thereof.

Socialism is a system that provides economic, political, and cultural conditions for the multifaceted development of the human personality. Hence, it follows that socialism is a system of human freedom, both political and economic. Ideally, any personal choice of an individual in a socialist society should be determined only by inner motives and should not be restricted by any outer circumstances, whether material or political. An individual's freedom should be restricted only when it harms the freedom of another.

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The socialist economic system is based on merging the owner and the worker into the same individual. We have learned from our experience that centralized planning and state ownership, at least in their present form, do not accomplish this goal. They retain the system of hired labor and the alienation of humans from the products of their labor. Today, we believe that a market economy in which all forms of ownership are equal will allow us to move closer to this goal.

All of the above, incidentally, begs the conclusion that the principles defended by Murray—a competitive market economy, close human bonds in little platoons, limited government, and a policy that does not take the trouble out of things—are not in contradiction with our contemporary notions of socialism and of the prospects for its development.

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Economic and Political Perestroika

Alexei Yemelyanov

The restructuring (perestroika) now under way in the USSR involves designs for change so profound that it can be called a true revolution. This restructuring comprises radical alterations in every aspect of society. But, as with any revolution, all the various changes, taken together, amount to a radical overhaul of the structures of power and property, and consequently of politics and economics. Reform of the power structure, after all, always means change in the political sphere, and property reform implies deep change in the economic sphere. The change in politics and economics in the course of perestroika is meant to transfer power and property to the people, to make every citizen a true master of his life, and to secure him the protection of the rule of law.

Economics and Politics

Economic and political perestroika are interrelated. This relationship reflects the close links between power and property. Objectively, genetically, power stems from ownership. Those who own property have power. The relationship between economics and politics is the same. Economics is the basis of politics. That is the picture we get if we consider the question from a developmental, epistemological point of view. But in real life, there is also a reverse connection. Power and politics have an impact on property and economics, defining their nature and their development. Those in power use their power to dominate the economy, to take it over as property. Politics has a strong influence on the economy in any society and at any time, but especially in the political system that has taken shape in the Soviet Union. It is important to take this into account in order to understand the problems and difficulties of today's restructuring.

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Under the authoritarian regime that prevailed in the USSR, politics always took precedence over economics. Political democratization defines the limits of the democratization of economic life. This is confirmed by the entire course of the development of the Soviet economy over 73 years, by its cyclical patterns. In the pre-Stalin period, the country's politics were relatively democratic—and this allowed for a corresponding democracy in the economic system: multiple forms of ownership and widespread economic self-sufficiency combined with incentives and accountability. The development of Stalin's authoritarian regime in the political sphere became incompatible with democratic principles in the economy. Economic pluralism and autonomy made workers independent and difficult to order about. Democracy in economics was interfering with the development of an authoritarian regime in the country. That is why the economy, along with politics, was made over into a command model.

In the years that followed, a certain cyclical pattern of economic development was clearly shaped by political changes. In the first five years of Nikita S. Khrushchev's rule, between 1953 and 1958, the economy moved forward; the effect was truly explosive. Then it began to decline. The same was repeated under Leonid I. Brezhnev: in the first five years (the 1966–70 five-year plan), the economy went through a period of growth; in the early 1970s, it was all downhill.

Why did such cycles occur? Why did the growth phase last for about five years in each case, while the decline phase lasted indefinitely? The cause of this pattern was rooted in politics, in the replacement of the top political leader and change in the structure of his power. A new leader needs time to establish his authoritarian rule. A relatively democratic, collective leadership style is established in politics. This opens some breathing space for economic democratization (relative freedom of decisionmaking, incentives, and so on). However, the country did not have an institutionalized legal mechanism to protect democratization. In such conditions, a term of about five years was enough for a leader to crush everyone under his weight and establish his authoritarian power. The establishment of such a political structure could not tolerate democracy in the economy. Democratic principles in economic life were consistently stifled—and, inevitably, the economy went downhill. The downward curve of the economic cycle continued not just for five years but until the replacement of the country's top politician.

The Slow Pace of Reform

It is not out of intellectual curiosity that I am delving into recent history. Without such an analysis, it is difficult to understand the

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problems and complications of change in the economic and political systems, of the democratization of society and the development of the rule of law. The correlation between economics and politics that existed on the eve of the current revolution is having an effect on their transformation in the course of perestroika. In both spheres, reforms are proceeding slowly; no radical changes have taken place. That is why we have yet to see the transformation we expected in the domestic life of our country—despite radical change in the foreign policy of our leadership. An evident gap has developed between radicalism in foreign policy and slow rate of change in domestic life, economic and political. This blatant contradiction has a logical basis. Radical change in foreign policy can be implemented, for some length of time, without fundamental change in power and property structures. However, a cardinal transformation in domestic life, in domestic politics and economics, inevitably means change in the structures of power and property. Yet we know from history that there has never been a revolution in which the ruling elite voluntarily conceded its power and property; it has always held on to them. Our experience is a stark example of this. Glasnost has been the principal domestic manifestation of perestroika, yet even glasnost, in many ways, is measured out in doses. In other areas, there is little radicalism, which is why living conditions have not only failed to improve but have actually deteriorated, threatening the peaceful course of our revolution.

The cause, in my opinion, lies in the same relationship between politics and economics that existed prior to perestroika, and in the inertia and conservatism of the main link in this relationship: the political system. Even in the course of perestroika, politics continue to dominate the economy. The slow pace of political change has held back economic change as well. Such a conclusion may seem all the more startling considering the conventional wisdom on this issue. Many, including some leaders, believe that economic change is supposedly lagging behind political reform. That is said to be the cause of our present trouble, but that view is far from indisputable.

Dominance of the Communist Party

Political change has affected, as previously noted, mainly glasnost (freedom of expression). As for the substance of the political system, there was only some patchwork. The core of the political system, its pivot, is the Communist party with its *apparat*, with its monopoly on power. And this, until quite recently, remained not just essentially but even formally unchanged. Only the elections to the federal parlia-

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ment in the spring of 1989 gave something of a jolt to the party's power. The upper echelons of the party were not ready for it. That election and the First Congress of People's Deputies of the USSR essentially started the process of the transfer of power from the party to bodies of democratic power. This process received a boost from the elections of republican and local councils (Soviets) of people's deputies.

However, this is mostly a process of formal transfer of power. On the other hand, real power—even after the new Soviets were formed—remained in the hands of party agencies. Moreover, the politicization and development of democratic power, like scientific and technological progress, proceeds at a different pace in different areas of the country. Moscow, Leningrad, Kuzbass and some other regions are ahead. They are showing us the way of the future, blazing the trail of democracy for other regions too. Here, the process of the transfer of power from the party to democratic bodies has come a long way. Yet on the whole, even now, real power in most regions still belongs to the party agencies.

The party agencies in power have been consistently, throughout the period of perestroika, demonstrating their desire to hold on to power. Thus they have been the main barrier to perestroika, holding back the democratization process as best they can. It would seem that, since they proclaim themselves to be the vanguard of society, they should have been in the front ranks of its democratization. On the contrary, however, they have stifled radical proposals and demands coming from the popular democratic movement, which has taken deep root. This anti-reform mentality applies to all issues, including the abolition of Article 6 of the Constitution, the acceptance of a multiparty system, and the occupation of leading posts in party and state bodies by the same person. The party has resisted every innovation. And if it does take some steps, it is always out of necessity and under public pressure.

While publicly endorsing the transfer of power to the Soviets, the party establishment has been, in effect, taking over the Soviets of people's deputies. Virtually everywhere, leadership posts have been merged, the secretary of the Regional Party Committee also taking the job of chairman of the local legislature. The 28th Congress of the CPSU and the Congress of the Communist Party of Russia have demonstrated the Party's conservatism, its inability to pursue radical change in a democratic direction. And since the Communist party is still a ruling party with monopolistic power, its conservatism is holding back economic and political reform.

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Ownership and Control

Radical economic change is inextricably linked with radical change in ownership—a change that would deprive the current political system of its base and undermine the power of the party. That is why, in all the years of perestroika, there has been no radical economic reform, just partial modification.

The specific directions of economic reform have varied. Generally, the changes have consisted in proclaiming policies meant to expand autonomy and worker participation in management, and to encourage a sense of control. The fact that all of this boils down to slogans and declarations reflects the nature of the changes: keeping the essence of the administrative command system while fixing it up a little. Indeed, there never was a question of letting the collective, the workers of an enterprise, take control and manage their affairs freely and autonomously. These plans had a different bent: to allow workers merely to participate in management, to have a sense of control as opposed to actual control. Logically, such an approach implied that there was no intention of turning workers into owners.

The basic and obvious fact is that only an owner can have true control. Under the system of state ownership that has developed in this country, workers have been essentially alienated from and deprived of property. Property was under the absolute control of the party and state *apparat*. And this *apparat* has tried, through the years of perestroika, to keep its economic base of state ownership intact. Proposed economic changes dealt only with particulars; in essence, they did not affect ownership. This became all too clear during the work on proposed legislation, especially legislation on property and land. The legislation that was ultimately passed did not reflect the radical proposals for the restructuring of property ownership, including recognition of private property. The dominance of ideology over economic policies stood in the way. The lack of positive economic results is a natural outcome.

Radical Political and Economic Change

Today, we have entered a stage when the fate of perestroika itself is at issue. To save it, we need radical political and economic change.

Political Reform

With regard to political reform, it is especially important to (a) establish a genuine multiparty system, (b) separate the functions of party and state structures, and (c) establish democracy and a rule of law.

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True democracy is impossible without a multiparty system. A multiparty system has now been recognized—but, so far, the recognition remains in many respects a mere formality. The emerging parties lack the prerequisites needed to establish a solid base and to assert themselves. The forces of the democratic left lack unity. An important task is to unite them into a democratic movement that could become a real social and political force—one that could compete with the CPSU and propel the CPSU toward either radical democratic self-transformation or withdrawal from the political arena.

The genuine self-assertion of other parties will also lead to a separation of functions between party and state bodies. In this repsect, it is vital to put an end to the current practice of one person combining leadership posts in the local party structure and in the local government. The resolution of the Russian Parliament banning such practices within the Russian Republic is an important step forward. So far, this legislative decision has been sabotaged in most regions by the party *apparat*. In some areas, party bosses have left their Regional Party Committee posts and begun to work as chairmen of the local soviets of people's deputies. Clearly, it is unlikely that these people with their party training will work to establish democratic power.

The new soviets of people's deputies are going through a difficult stage in their development. Many deputies have no political experience, which has an adverse impact on the effectiveness of the Soviets' work. We should take into account the fact that in many cases, the local party machine does all it can to discredit the new power in the eyes of the voters, to shift the blame for the current hardships from themselves to these new elected bodies.

The goals of strengthening democratic power and establishing the rule of law pose before us the task of streamlining our current system of government. Today, our system is very complicated, and it is difficult to separate the functions of various levels of government. The introduction of the presidency and the creation of the presidential council has further complicated things a great deal. This council is being expanded in size, yet it is unelected and is not accountable to the parliament. It is difficult to understand the separation between its functions and those of the cabinet. The roles of the cabinet and the Supreme Soviet alike have been reduced. This complicates the already difficult process of democratization.

A radical yet at the same time cautious approach is needed in solving the problems of political structure. Here, conservatism has flourished more than anywhere else. The political structure had remained unchanged since 1922. Since the first years of perestroika, democratization has also spread to this sphere. Union republics have

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demanded greater autonomy and a new Union treaty. The central party structures, as usual, took a conservative stance. This position of the center propelled the republics toward sometimes ill-advised independent decisions. Nearly every republic in the Union has adopted a declaration of sovereign statehood. Similar decisions are being made by autonomous republics. A new image of the Union is taking shape—as a confederation rather than a federation. Today, the positions of the republics are being smoothed out and coordinated with the central authorities in order to prepare for a new Union treaty.

Radical Economic Reform

Improvements in the political system, in the directions indicated, must be accompanied, without further delay, by radical economic reform. Today, there is heated debate on these questions, related to the proclaimed transition to the market economy. This is a complex process. Let us single out some of the most topical problems.

First of all, there must be a change in property ownership. Property must be denationalized and a number of enterprises transferred to private, collective, or joint-stock ownership. This change will truly make possible the multiple forms of ownership that have been recognized as proper for our economy. The problem of ownership exists in every branch of industry, but it is especially important in the agrarian sector. To help farms and peasant cooperatives get on their feet, it is appropriate to introduce private and collective ownership of land. The development of new forms of management must be facilitated in every possible way.

The transformation of property ownership will allow the existing potential to be used more effectively, stopping the decline in the population's living standards. A great deal can be accomplished, too, by improving structural policies—specifically, the structures of exports and imports, the former consisting primarily of raw materials and the latter of foodstuffs. Annual food purchases amount to about 21 billion dollars—yet, at the same time, we lose much more of our own output than we buy. The investment complex, with about 400 billion rubles tied up in it, is wasteful and inefficient.

The use of these and other reserves will allow us to make the transition to the market without sacrifice on the part of the population, without a drop in its living standards. On the other hand, the program presented by the government to the Supreme Soviet emphasized an across-the-board increase in consumer prices and a decline in living standards. Surely, this last straw would have heightened social tensions and created an explosive situation.

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The transition to the market requires a thoughtful approach to the question of government regulation. An academic approach is unacceptable here; real life must be taken into account. We have a staggering budget deficit and an extremely unbalanced economy. That is exacerbated by the effects of organized sabotage. There is no fine-tuned system of direct communication between enterprises. The ruble is not working; free operations (outside compulsory state contracts) are usually based on barter. If, in such conditions, state contracts are rejected or their share in the economy drastically reduced, this will lead to a breakdown in communications, to even greater imbalances and a sharp drop in output in many spheres. That is why it is necessary to retain well-considered government regulation, loosening it as the economy improves.

Conclusion

One may say that perestroika in our country has entered a critical stage. The conservatism and inertia shown by the leadership in the first four to five years made it impossible to achieve radical change in the economy or in the political system. That is why the radical breakup of the old system today is not always proceeding in a balanced manner and sometimes takes explosive forms. That is why we so urgently need a reasoned, balanced approach to solving the intertwined problems of political, economic, and government reform. Otherwise, our revolution will be thrown off its peaceful course and may assume other forms. It is our common task to prevent this from happening.

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Insulating Economics from Politics: Toward a Constitution of Liberty

James A. Dorn

> You cannot change the form of property without changing the form of power. . . . [I]n Communist countries the economy, in the final analysis, is the means of politics. The economy is ruled and controlled by politics. You must change the political system first, because it is a tyrannical regime without respect for laws.
>
> —Milovan Djilas[1]

Some Basic Questions

Can economic life be insulated from political life? And, if so, why has this separation not occurred in the Soviet Union, or even fully in the United States? To address these questions, one must first define "economic life" and then consider how it can be insulated from political life.

For our purposes, economic life can be thought of as the process of making choices in a world of scarcity where some form of competition takes place to determine "who gets what." The problem of economic life, in essence, is a problem of pricing and property (Alchian 1967, p. 6). Consequently, the answer to the question of whether economic life can be insulated from political life hinges on the question of whether pricing and property can be insulated from politics, or more specifically, whether constitutional constraints can be implemented and maintained to limit the range of political action as it affects economic liberties. These questions were fundamental to the 18th-century American Revolution and are at the heart of the liberal revolution that is sweeping Eastern and Central Europe as well as the Soviet Union.

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[1]Cited in Hornik (1990, p. 18).

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Competing Visions

The choice of the property rights regime and the choice of the political/constitutional regime depend on ideology, that is, on how one views the role of the market and government in organizing economic life. Two competing visions can be discerned: (1) the liberal vision that traces back to Adam Smith and other classical liberals, and (2) the socialist vision that is associated with Karl Marx and Vladimir Lenin.[2] Let us briefly examine each of these visions and consider their implications for insulating economic from political life.

The Liberal Vision

The key feature of the liberal vision is that economic and social order will emerge spontaneously when individuals are free to choose and when property rights are protected by law. Such a vision takes individual self-interest as a given. The institutions of private property and government by law are then added to ensure that self-interest is compatible with the rights of persons and property.

Experience has shown that the wealth of a nation is best advanced when markets are free and when government is instituted primarily to protect persons and property. That government should be so limited was taken for granted by the framers of the U.S. Constitution. James Madison ([1829] 1865, p. 51), the "chief architect" of the Constitution, wrote:

> It is sufficiently obvious, that persons and property are the two great subjects on which Governments are to act; and that the rights of persons, and the rights of property, are the objects for the protection of which Government was instituted.

When individuals know the bounds of government and are free to trade, they will be able to use their knowledge and skills to gain material advantage in a *mutually* beneficial way.

In the liberal vision, economic life is effectively insulated from the state by a "constitution of liberty," to use F. A. Hayek's expression (Hayek 1960). Such a constitution limits the range of democratic/majoritarian rule, protects property rights, and lays the basis for a spontaneous market order. In this "system of natural liberty," as Adam Smith ([1776] 1937, p. 651) called it, the private market system generates rational prices and coordinates individual plans. Since individuals are held accountable for their use of scarce resources, there will be an incentive for resources to move to their highest

[2]For a more detailed discussion of these competing visions, see Brunner (1983) and Sowell (1987).

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valued uses. Enterprises that ignore consumers' preferences will not survive; consumers, not planners, are sovereign.

Classical liberals see a just government as one that provides equal protection under the law so that private rights to "life, liberty, and property" are secure. It is in this sense that Thomas Jefferson ([1801] 1989, pp. 15–16), one of America's greatest liberals, wrote:

> A wise and frugal government, which shall restrain men from injuring one another, which shall leave them otherwise free to regulate their own pursuits of industry and improvement, and shall not take from the mouth of labor the bread it has earned. This is the sum of good government.

When the state steps away from its primary function of protecting property and begins to take property for redistribution at will, the character of the state drastically changes—from that of protector to that of predator. The further this process is carried, the greater will be the politicization of economic life. In the United States, the economic clauses of the Constitution—protecting property rights, contractual freedom, and interstate trade—have been seriously eroded (Niskanen 1988). Since the late 1930s, the Supreme Court has not afforded economic liberties the same protection under the law as other liberties, such as freedom of speech and freedom of religion (Pilon 1987). Activist legislatures have taken the signal and opened the door for all sorts of direct and indirect transfers.[3] In the process, government has grown to a point that would shock the Founding Fathers.[4]

The heavy tax, regulatory, and debt burdens that accompany the modern welfare state have hampered the market's wealth-creating potential and stifled economic life. Even so, the U.S. Constitution and Bill of Rights, though eroded, have constrained government and allowed the market system to survive. No such constraints, however, are present in the Soviet system, where the Communist party has held a monopoly over both political and economic life.

Thus, unlike the United States, the Soviet Union is characterized by virtually total politicization of economic life. Larissa Piyasheva (1991, pp. 281–82) has brought this point out well:

> The causes of the present-day inefficiency of our economy are rooted not in the poor diligence of our people, not in their sloth or indolence, drunkenness or truancy. . . . The causes reside else-

[3]Government transfer payments have risen from less than 1 percent of GNP in 1929 to about 12 percent in 1991. Federal transfer payments accounted for 40 percent of federal outlays in fiscal 1991. For a discussion of the rise of the so-called transfer society, see Dorn (1986).

[4]In fiscal 1991, total government spending in the United States amounted to about 42 percent of national income.

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> where—in the fabric of our economic life subordinated to political goals. . . . The trouble is that our economy does not serve its main purpose and designation—to feed people and make their life comfortable. It is pegged to politics, to political power.

Likewise, Alexei Yemelyanov (1991, p. 270) argues,

> Under the authoritarian regime that prevailed in the USSR, politics always took precedence over economics. Political democratization defines the limits of the democratization of economic life.

The Marxist-Leninist Vision

For more than 70 years, the Soviet Union has been dominated by one world view, that of Marx and Lenin. According to the Marxist-Leninist vision, the state, not the individual, is sovereign. Property and resources are concentrated in the state, and individual rights lose their meaning. Consequently, under socialism, all economic decisions become political decisions. Those in power, for example, can set below-market prices and then ration goods via nonprice competition. "Who gets what" will be determined not solely by the prices individuals are willing to pay but also by proximity to those controlling the political-economic hierarchy (Alchian 1967, pp. 13–14; Cheung 1990, pp. 27–28).

In the Marxist-Leninist vision, the first step toward communism is to abolish private property. Thereafter, the Communist party's task is to keep tight control over political, economic, and social life. During the transition to communism, the state is to wither away until, in the end, everyone is to be free from the state and free from want. In reality, without private property, the Soviet state has grown and material progress has languished.

Under socialism, which is the first stage of communism, the state becomes more, not less, powerful. Without effective private property rights and a rule of law, there is nothing to limit government discretion, nor is there any automatic feedback mechanism to make individuals responsive to changes in economic conditions. Without the ability to capture rewards from efficient management of resources or to bear responsibility for inefficient use, socialist managers will trade off the wealth of their firms for personal gain whenever possible. As such, corruption will be a constant problem under state ownership.

The absence of a profit-loss test and the lack of bankrupcy as a tool of discipline mean that socialist managers will not feel the competitive pressure to respond to consumers' preferences. As Nikolay Shmelyov (1987) stated, "The basic vice of our current economic system is the total irresponsibility of the upper levels of the pyramid, the absence of any 'feedback' from below."

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Under state ownership, risk is socialized and individuals have little incentive to maintain either their human or nonhuman capital. Without a real set of markets and prices, adjustments to changing economic conditions must occur through the bureaucracy. The rigid nature of central planning and control means that the adjustment process under socialism will be sluggish at best. Errors will accumulate and cracks in the economic landscape will widen until the time of total collapse. The only way to release the pressure and remove the distortions is to make a clear and radical shift toward a private market system—something planners have little incentive to do.

Given the lack of private property rights and the attenuation of individual freedom under socialism, it is no surprise that the Marxist-Leninist vision has led to a growing role for the state and an ossified, rather than spontaneous, economic order. "During 70 years of socialist experimentation in Russia," writes Alexander Tsypko (1991, p. 290), "not one major problem that the country was facing in 1917 has been solved."

The reality of the failed socialist experiment contrasts sharply with the vision of Lenin ([1917] 1963, p. 418), who proclaimed: "We have a right to say, with the fullest confidence, that the exploitation of the capitalists will inevitably result in a gigantic development of the productive forces of human society."

The problem with the Marxist-Leninist vision is that it clashes with the reality of scarcity and ends up destroying the very institutions—property and contract—that are the basis of civil society and material progress. It is wishful thinking to believe that the economic problem of society can be solved in a satisfactory manner when freedom of choice and equal protection under the law are absent.

A Constitution of Liberty

The politicization of economic life under socialism means that economic reform requires political reform or, more correctly, constitutional reform. To insulate economic life from political life requires a constitution of liberty—a constitution that protects private property and provides for equal freedom (not equal outcomes) under a rule of law.

In the transition from socialism to market liberalism, therefore, one can benefit from the advice of Adam Smith ([1759] 1976, pp. 380–81), who warned against the "man of system" and the politicization of economic life:

> The man of system . . . seems to imagine that he can arrange the different members of a great society with as much ease as the hand

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> arranges the different pieces upon a chessboard; he does not consider that the pieces upon the chessboard have no other principle of motion besides that which the hand impresses upon them; but that, in the great chessboard of human society, every single piece has a principle of motion of its own, altogether different from that which the legislature [or central planning agency] might choose to impress upon it. If those two principles coincide and act in the same direction, the game of human society will go on easily and harmoniously, and is very likely to be happy and successful. If they are opposite or different, the game will go on miserably, and the society must be at all times in the highest degree of disorder.

The post-Soviet challenge is to accept the idea of spontaneous order and to adopt a constitution of liberty that will set the framework for a free-market system. The transition from plan to market, therefore, requires discarding the ideological baggage that has hampered clear thinking about the role of private property rights in insulating economic life from political life.

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Revitalization of Socialism or Restoration of Capitalism?

Alexander Tsypko

The Myth of Convergence

The ideology of reconciliation and the combination of communist and traditional, so-called capitalist, forms of production and society have proved virtually bankrupt. It is obvious without any experiment that convergence (merging what we called "socialism" and what was the stuff of our lives with the characteristic features of the developed Western countries) is impossible in principle. The idea of converging the two systems was a reflection less of the needs of the development of human civilization than of the despair of common sense, as the peoples of Russia and Eastern Europe lost all hope that they would be able to end totalitarianism by themselves. Hence, we arrive at the pessimistic prognosis about the long-term historical interaction of Western democracies and left-wing totalitarian régimes. We also find the concessions of Western theoretical thinking, the tendency to mythologize our achievements in planning and centralizing industry, and the forgetting of the basic truth that only efficient production can be efficiently regulated. We forget that Soviet centralism, based on fear, was essentially impossible to reproduce in different political and cultural circumstances. Fire and ice cannot be put together. The fire will melt the ice, and the water from the melting ice will put out the fire. And there will be neither fire nor ice.

Even before perestroika, before our attempts during the past five years to revive Soviet industrial and social structures with the help of borrowed economic mechanisms that we spied on the other side of the fence, we could have predicted the groundlessness of these hopes to reconcile the irreconcilable.

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As early as 1978, the well-known Polish economist Stefan Kurowski wrote that hopes to reform Soviet-type economies were in vain, that it was impossible to make the transition to efficiency without completely rejecting the ideological basis of planned economies, the labor theory of value, the ideal of directly socialized labor, and the principle of the primacy of politics over economics. At the time, not only in the USSR but also in Poland, Hungary, and Czechoslovakia, a considerable part of the progressive, democratic intelligentsia believed in the possibility of a "third way"—the creation of a "true," "pure" socialism opposed simultaneously to so-called Stalinist, barracks-style socialism and to modern capitalism with all of its ills. It is no accident that many Polish party commentators who joined Solidarity in 1980 worked on a conception of "Polish homegrown socialism" and advocated purifying socialism of various distortions. Later, in the mid-1980s, reformers in the leadership of the Socialist Workers' Party of Hungary were similarly motivated. On the whole, one may say that in the 1970s and even in the 1980s, the intellectual attitudes of Soviet and East European countries were motivated by the ideals of the Prague Spring of 1968. The dream of "socialism with a human face," which took hold in the mind of the Eastern European intelligentsia, not only stimulated democratic initiatives but at the same time gave them an ideological legitimacy. As late as December 1989, during the collapse of the political structures of East Germany, the overwhelming majority of that country's intellectuals continued to believe that a "pure" Marxist socialism was possible and that the people of East Germany would be able to accomplish what "the Russians or Poles, who never understood Marx properly, could not do." I believe that the idea of convergence, of "combining the advantages of true socialism and a market economy," was most fully and consistently realized—only on paper, of course—by the authors of the well-known "Socialist Project" prepared in late 1989 by philosophers and economists of the Humboldt University in Berlin.

As we survey the results of more than five years of our efforts to revive the socialism built in the USSR during the 1930s, it becomes clear that we all had to go through this syndrome of the third way. There were many reasons. First, the mentality of people who had lived their entire lives in totalitarian societies, or rather who had led their existence in conditions they consider unnatural, took its toll. It is hard—very hard—to admit that your life and your work are being senselessly wasted and that you are living in an unnatural, false society, headed with your country for the dead end of history. Therefore, the hope that real socialism—a real socialist economy would be, in the end, successfully revitalized and made more rational—was

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a comfort to the soul and enabled people to bear the hardships of everyday life. No less importantly, many people found it difficult to reject the socialist legitimacy of their state with its Marxist ideology. Having made such a step in the conditions of the Communist party's monopoly on power, the reformer ceased to be a reformer and became a traitor to the ideals of socialism with all the ensuing consequences. Hence, it is no accident that not one of the reformers of Eastern Europe spoke of the obvious: the need to restore the market and the civil society, and the need to save the life still left after socialist transformation. However, everyone spoke in unison of the need for economic or radical reform; these advocates were unaware that, in doing so, they were paying tribute to utopia and were giving a meaning to the initial and most tragic stage of socialist construction.

Reform from the Top

It was even more difficult to avoid this transitional ideology in our country, burdened by our communist birthright in a country that had sacrificed tens of millions of lives in the name of the chimera of the Communist Eden. What makes perestroika different from the democratic revolutions of Poland, Czechoslovakia, and East Germany is the fact that it began from the top, at the initiative of the ruling Communist party. In Poland everything was started by the opposition—Walesa, Kuron, Michnik; here everything was started by the *apparatchiks*—Gorbachev and Yakovlev. The latter not only generated perestroika but created their own opposition. In Poland or Czechoslovakia, the people capable of heading a reformist movement were outside the party; from the very beginning, their political activity was directed at dismantling the party and state structures. Therefore, from the beginning, the struggle in these countries was against the communist legitimacy of the state, against communism and socialism. Here everything was different.

Since perestroika began inside the party, it could be declared only as an initiative directed at strengthening the position of socialism and of the party, as a campaign for a more adequate understanding of Marxism-Leninism. Perestroika began within the framework of the communist legitimacy of our state and, in its conception, was intended to strengthen the socialist and communist nature of our society. Here, again, characteristics peculiar to Russia were in evidence. Typically in our country, with the exception of the 1917 revolution, all revolutions are launched from above and are intended by their initiators as a means to fortify the existing system. This

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applies to the revolutions of Peter the Great and Alexander II. This path of reform from the top has both advantages and disadvantages.

On the one hand, reforms from above ensure the preservation of the old consensus and an unbroken thread of political development. Stability can be preserved during reforms, and the disintegration of society can be avoided. Reforms from the top also allow the democratically oriented segment of the party and government apparatus to be involved in the changes. We should not forget that here, unlike in Poland, Czechoslovakia, and Hungary, the best-qualified and most-authoritative segment of the intelligentsia was integrated into the party and had close links to it.

At the same time, however, the policy of reform within the framework of the old communist legitimacy of our state, from the very beginning, tied the hands of reformers and shackled the planned democratic changes in society. Revolution from the top and within the framework of communist legitimacy was a barrier to serious and profound analysis of the sources of our mistakes, our crises, and our deepening stagnation. It was a barrier to the full truth about our socialist choice and its consequences.

Failure of Half-Measures

From the start we were doomed to half-measures, doomed to fail. We saw and understood that state ownership of industry was inefficient, that it shackled the development of productive forces. But since we were still communists and still insisted that the socialist choice was correct, we were forced to defend the idea of nationalization, of socialized means of production. Thus, while issues of denationalization, privatization, and transition to a market economy were being raised in Poland, Czechoslovakia, East Germany, and Hungary, we had to restrict ourselves to cost accounting at state-owned enterprises. We had to combine the market with the government monopoly on industrial organization. This inconclusiveness and inconsistency had an especially strong effect on our decisions of 1987, which were the basis of the reforms that were carried out.

We were saying that the peasant would become a farmer only when he became an owner—and that was true. But we still insisted on the correctness of the socialist choice. We did not dare give land to the peasants or make them owners of the land they cultivated. Instead of denationalizing the land, we went no further than leaseholding within the framework of the existing collective farm and state farm system of labor organization.

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We demanded a return to civilization, to the primacy of universal human values; it was on this basis that we attacked the crimes of Stalin. But we defended the Marxist teaching about revolutions and about the efficacy of revolutionary violence in Russia; we justified the Red terror and the suffering it inflicted. Because of all this, our ideology was rife with blatant contradictions.

As early as 1986 we spoke of the need for the rule of law. But we insisted the Soviet Constitution retain its article on the leading role of the Communist party in our society. We criticized even the possibility of adopting a multiparty system.

As it turned out, the very logic of the development of life has nothing in common with the laws for preserving the former communist legitimacy. Whatever can be invented by a person who is trying by all means to stay on the socialist platform cannot be carried out in real life. Leaseholding is fine in theory, when one needs a legal way to get away from Marxism and from the idea of socialized agricultural labor. Compared to the old Marxist agrarian program, the idea of leaseholding looks quite revolutionary. But in real life, to the peasants themselves, it looks like yet another ploy of the régime that has always cheated them. There is, after all, no guarantee that the régime will keep its word and will not confiscate the land they are leasing. Soviet peasantry as a whole has not accepted leaseholding; peasants are willing to farm independently only if the land is their own. It is equally impossible to combine in one's heart a moral condemnation of Stalinist terror with love of the Red terror of the civil war.

Impossibility of Revitalizing Socialism

It took us five wasted years of perestroika to understand that, essentially, the revitalization of Stalinist socialism is impossible; there is no third way between modern civilization and socialism as it is. The market cannot be combined with a government monopoly on the organization of labor or with public ownership of the means of production. A return to the market is impossible without the restoration of various forms of private and collective enterprise, without broad-based privatization. It is impossible to have the rule of law without a multiparty system, without renouncing the communist monopoly on power. It is impossible to adopt moral values and to earn the right to return to civilization, to the European home, without rejecting the idea of the dictatorship of the proletariat, of the forcible transformation of society.

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In other words, owing to our five years of experience of trying to reform real socialism and to the experience of political economic reforms during the 1970s and 1980s in Eastern Europe, we realize the inevitability of facing the need to restore everything we had rejected during socialist transformation; we must restore the structures and institutions of civil society. Within the framework of the old socialist orientation, none of the tasks we are facing can be solved. We also have a question of creating incentives for efficient and quality work, plus a question of awakening a sense of citizenship and dignity in people. What we are witnessing is not the organic revitalization of socialism but the withering away of forcibly imposed economic and political structures. During 70 years of socialist experimentation in Russia, not one major problem that the country was facing in 1917 has been solved. The general culture of labor has not improved. In productivity of labor, not only have we failed to catch up with Western Europe but we are lagging even further behind. We are also further behind in human rights and freedoms. The nationality question remains unsolved.

Restoring Civil Society

Ours is, therefore, a question of a belated—at least by 60 years—restoration of the traditional structures of political and economic life. This task could have easily been solved in the 1920s or early 1930s, when all the necessary conditions were there—both the material prerequisites and the agents of restoration. Today, however, the task is extremely complicated. In any event, we must call things by their proper names and raise the issue of restoring severed economic and political connections. All we have to restore is what we rejected in 1917, the understanding that without the market, we are not going to build a normal, healthy economy. We understand that we have taken the wrong way and must now restore the Third Estate. Nor can we have, in our circumstances, the traditional agents of restoration. The paradox of history is that the Bolshevik party systematically and consistently eliminated over decades the organic structures of industry and social life and never allowed the remnants of a civil society to emerge in Russia, but now the Bolshevik party is forced to assume responsibility for restoring a world it once fought. Will it be capable of solving this task? Will it be able to restore the ground on which, essentially, there will be no room left for its rule?

We have yet to find a convincing answer to this key question. Nor has the 18th Congress of the Communist Party of the Soviet Union answered it. The party reformers could not, after all, neutralize the

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dogmatists' attempt at a rollback. It is beginning to look as if the Soviet Communist party itself is no longer capable of fully carrying out the reforms it started.

Also noteworthy are natural differences between the various segments of society and the spheres of social life in preparedness for restoring the traditional institutions and mechanisms of civil society. We must recognize the fact that some social institutions simply cannot be restored in this country. We cannot restore the traditional type of Russian craftsman or merchant. Many, many things have been irretrievably lost.

Many, many people in our country today are beginning to understand that it would have been better if the October Revolution had been avoided; that the Bolsheviks interrupted Russia's natural development; and that we need to return to a normal life, to private property, and to entrepreneurship. People are beginning to understand that not everything was bad in old Russia. However, things that can be imagined are sometimes impossible to carry out in real life. Mentally, we can go back in time. But in real life, it is infinitely more complicated. It has been relatively easy for us to restore the continuity of time in culture and in historical memory; we can easily return to the philosophical and literary values we rejected in 1917. It has been relatively easy for us to restore the trampled rights of Christianity and Islam. There is no doubt that in another year or two, thousands of churches will rise from the rubble.

Even the restoration of the multiparty system is probably possible in this country. Of course, until normal social structures are formed from social dust and until the specific interests of different classes and social groups are defined, we will be dealing, essentially, with a surrogate multiparty system. It was no accident that in Poland a new one-party monopoly has replaced the old one-party monopoly; all other political parties except Solidarity are incapable of exercising a tangible political influence.

It is evident that changes in consciousness and in the expectations of people—particularly of that portion of society that is actively involved in perestroika—are occurring much faster than changes in real life.

Even in Poland, Hungary, and Czechoslovakia, where communism has suffered a complete political and ideological defeat, people must live with the same old economic realities; they must reconcile themselves to the old state socialism that has proved impossible to discard.

The experience of the latest economic reforms in Poland is especially characteristic in this regard. The population itself does not have the means for the privatization of state-owned means of produc-

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tion. At the same time, Western businesspersons have no interest in acquiring enterprises with obsolete, ecologically unsound industrial equipment. Certainly, no one is showing much interest in the structurally backward Polish industry. The Balcerowicz plan does nothing to stimulate the economic recovery of large industrial enterprises that remain in a monopolistic position. That is why the so-called post-communist countries of Eastern Europe are—in essence, in their economic structures, and in the mentality of the vast majority of the working class—still communist.

There is no need to prove that this gap between the speed of the defeat of communism and communist ideology in the people's minds and the speed of their defeat in everyday economic life may very soon become a source of psychological tension. Such a belated restoration of civil society is an unprecedented phenomenon in the history of humankind. Therefore, we should be ready to solve social problems that no one ever had to solve before.

The Paradigm of Restoration

Today, everyone is talking about the need to reject the communist Marxist legitimacy of our society. But can we, after 70 years of communist existence, return to the traditional and historical legitimacy of our state? No signs of such a transition can be anticipated so far.

All of this suggests the need for a global, broad, historical look at the processes occurring today in post-communist countries. It seems to me that the transition from the paradigm of reform to that of restoration can allow us to better understand what is happening to us and what tasks lie ahead.

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Economic Reform: A Great Bubble or a Faint Chance to Survive?

Larisa Piyasheva

Directions of Economic Thinking

In the monolithic ranks of our economists, three directions of economic thinking—though not yet schools of economics—have taken shape. The first is the currently unpopular conservative bloc of traditional *Marxists* who defend our socialist achievements and want stabilization within the framework of state ownership and a planned economy. The second is that of *market socialists*, of social democratic orientation, who are seeking all sorts of compromise combinations of free markets with our currently existing structures of property and power (they are the absolute majority today and form part of the Gorbachev team). Finally, there are *market radicals* who are calling for straightforward privatization of property and free markets. They are a tiny minority.

I consider myself to be a part of the last group. I reject all models of socialism, the Marxist-Leninist or the social democratic. My views are based on the theories of the Chicago school, and I believe that all attempts to find a "third way" are headed for a dead end. What I would recommend to our government for a transition to the market is the Erhard model of the "social market economy," with Friedrich Hayek and Milton Friedman, or their disciples and followers, as consultants and advisers. I am absolutely and firmly convinced that our country has accumulated a large potential of unutilized creative

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and entrepreneurial initiative, which, provided that our totalitarian/administrative mechanism is quickly dismantled and people are given their civil rights and freedoms, can bring about radical changes in our lives.

Necessity of a Radical Market Breakthrough

Even though communist ideology is beginning to retreat quietly, it remains a potent force that holds back our economic development. Economic theory is still labeled "market capitalist apologetics" in this country. Several generations of political economists, including academicians, Ph.D.s, and junior members of the Academy of Sciences have been raised on such doctrines. And even though most Soviet and many Western socialists and social democrats do not share my convictions, I would still like to communicate one simple truth: Unless we protect the fragile plant of liberal thinking now budding in our society, it will be very difficult to change things here. That is why, at this stage, I believe that the most appropriate slogan would be: "No compromise." If we get embroiled at this time in a lengthy process of discussions and lectures on pluralism and the equality of all forms of ownership—on the need to go through the transitional and halfway stages of leasing from the state, contracts, mixed public/private enterprises, and other forms of the "mixed economy"—we will get bogged down in verbiage for decades to come. We must make a radical market breakthrough, even if our communists and social democrats are not ready for it just yet.

When our government speaks of the impending transition to the market, what they mean is something very different from what this is taken to mean in the West. And when our official economists speak of economic liberalism, what they mean is something quite different from the liberalism of the free market with free pricing. This difference should be remembered every time one engages in debate or polemics with our scholars. With very few exceptions, most of them today are advocates of a regulated economy of the left-Keynesian type—at best. The idea of social justice, in its socialist, distributive interpretations, continues to stir their minds, prevailing over the principles of equal opportunity and freedom of private enterprise. If, five years ago, our scholars had approached their task responsibly, we would not be on the verge of economic bankruptcy today. In the five years of perestroika, not a single Western textbook of economics has been translated here. The vast majority of our undergraduate and graduate students, as well as our scholars, are not familiar even with the names of Nobel Prize-winning economists, let alone the broad

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spectrum of worldwide economic thought. On the other hand, look at all the pilgrims who have traveled to the United States seeking credits and most-favored-nation trade status.

Abel Aganbegyan (1990, p. 2) argues that "perestroika inherited a very difficult situation," in which there was a deficit in the state budget, a monetary overhang, and a dirth of consumer goods. But this is only partially true. We do, indeed, have a difficult legacy. However, perestroika itself has generated a manifold increase in the deficit, multiplied the money supply, and brought about a virtual collapse of what domestic market we had. The starting conditions of perestroika were far better than present-day conditions.

The cause of our troubles, according to Aganbegyan, is in "the dictate of the producers" and the resulting distortion in the economic structure, with the prevalence of heavy industry investments and military expenditures, and the financing of consumer goods and social expenditures relegated to the back burner.

His analysis is incorrect. If we really had a "dictate of the producers," the resources channeled into industrial units would have been utilized effectively, and today we would have a highly developed if hypertrophied heavy industry. The real tragedy is that producers and consumers in our society are equally deprived of rights, freedoms, autonomy, and responsibility.

The same goes for the military industry. Despite our gigantic military expenditures and the fact that all of our economy is geared toward the production of weapons, even this sector does not yield us the huge profits reaped by the Western military-industrial complex. Unreasonable though this may be, there is money to be made in guns and missiles too.

The problem, then, is not in the structure of our GNP or the "dictate of the producers." The problem lies in the underlying principles of our economic life, in the dictate of the regime that champions socialist principles and spends inconceivable amounts of money on sustaining this ideology. I am referring less to actual spending on the maintenance of the Communist party/ideological machine—with its institutes, chairs, newspapers, magazines, and academies—than to the tremendous losses the country suffers because it does not have a free-enterprise system.

Destructiveness of Socialist Ideology

Socialist ideology has turned out to be destructive to economic well-being precisely because, for several decades, it has fought enter-

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prise and rooted out all the productive groups and segments of society: industrialists, bankers, craftsmen, traders, and peasants.

The victory of socialism was in its ability to uproot virtually the entire populace, destroying and diffusing the functions of the entrepreneur among different parts of the administrative system. It also divided the functions of the market among the agencies of the state. The State Pricing Committee became responsible for setting prices, the State Supplies Committee for the allocation of resources, the State Labor Committee for the allocation of employment and the setting of salaries, the State Planning Board for the rate of economic growth, and the Ministry of Finance for the monetary cycle.

As a result, all citizens—blue-collar workers, white-collar workers, and peasants—were equally deprived of property rights, of the right to enterprise and to self-enrichment. That is the principal cause of our decline, before perestroika and to this day.

Absence of Real Reform

The trouble is that in five years of talk about perestroika, not a single practical step toward the market has been made in this country. The monopoly structure of power and ownership remains intact. The network of ministries in charge of various branches of industry has not been eliminated. Our economic structure is still the most monopolistic in the world. Not a single enterprise has been given complete economic self-sufficiency. The State Planning Board continues to dictate its terms. The State Supplies Committee continues to dispose of resources. There is still no wholesale market for raw and industrial materials, machinery, or means of production. The revenues of industrial enterprises are still taken into the government budget and centrally redistributed. Nor is there a law on bankruptcies. And thousands of factories, collective farms, and state farms remain afloat on government grants and subsidies, draining the country of its lifeblood.

In five years of perestroika, not a single practical step has been made to solve the problem of making the ruble convertible and normalizing our currency. Enterprises have been given no genuine opportunities for independent access to international markets. The cooperative experiment, for all intents and purposes, has failed: President Gorbachev has not found the courage to defend trading and mediating cooperatives from the conservative assault. What, then, do we have today?

Following in the footsteps of Mikhail Gorbachev and Leonid Abalkin, Aganbegyan and others essentially advocate the reanimation

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of socialism, giving it "a second wind." But it is precisely these "democratic socialist" precepts that have brought us to utter collapse. Having promised economic freedom and autonomy to people, the government's experts began to work on strategies designed to prolong the agony of the administrative command system for at least another five years and to avoid giving people property or freedom. Having permitted cooperatives and self-employment, the experts began at once to look for ways to strangle their creations with taxes, sanctions, and restrictions. And having permitted land leasing, government's experts made leaseholders completely dependent on the local monopolistic landlords—the collective farm and state farm chairmen who have done all they could to prevent the development of a private sector in agriculture. As for trading and mediating cooperatives, they were simply crushed by the party-Mafia-trade nomenklatura.

The highest manifestation of economic wisdom in the privatization plan was the authorization of leasing with the option of buying out the property from the state over 15 years. There is no need to prove that, if leasing in agriculture was strangled by the collective farm aristocracy, leasing/buyout in industry was a stillborn invention from the beginning.

Strategies of Transition to the Market

Abel Aganbegyan (1990) sees the transition to market pricing as a step-by-step reduction of the share of centrally fixed prices, with an expanding share of market prices. Structural perestroika is seen as a well-planned, gradual replacement of an obsolete fleet of cars with new ones—not through the mechanism of bankruptcy and the release of labor and capital, but by gradual replacement of the product line.

The transition to the market is seen as a succession of reforms spaced through time. First is the reform raising the prices calculated and fixed by the Council of Ministers and overhauling the pricing structure. Then, at the next stage, is the reform to balance the money supply with the supply of material goods and commodities. Then we find the establishment of the market infrastructure, the switch to multi-channel, commercial trading in consumer goods, and so on. The process of transition to the market is seen as a gradual increase in the proportion of goods supplied to the market, with a gradual reduction in high-demand goods that will be distributed centrally.

In five years, money and commodity markets are to develop fully, after which a convertible currency market is to be created, giving

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enterprises, organizations, and individuals the right to trade rubles for foreign currencies.

If such a strategy of transition is adopted, then I have no choice but to advise those who intend to give us credits to wait for five years, until the very day when individuals and enterprises are given the right to freely exchange rubles for hard currencies. I would also recommend that credits be extended only for very specific objectives, to the private sector, and certainly not through government or pseudo-social institutions. The first condition applies only to Aganbegyan's strategy of transition to the market; the second, to any option that is adopted.

The program prepared by the Ryzhkov cabinet is not, strictly speaking, a market program. It deals with an impending, administratively imposed price hike. As for the 500-Day Program, it is, unlike all the programs presented earlier, a market-based program. However, it needs major improvements when it comes to the strategic plan of transition to the market.

The Road to Serfdom

Thus, the initial incorrect diagnosis of the problem, the inclusion of socialist planners defending the interests of the state in the work on the government's transition plan, and plain economic illiteracy have combined to generate the devastating economic processes we are witnessing today. Aganbegyan's strategy of "perestroika-and acceleration"; Abalkin's program of "emergency measures"; the new government program that would raise all retail prices 40 percent, compensating two-thirds of it with additional payments and taking one-third of the excess money, with 86 percent of prices remaining centrally fixed and restricted and only 14 percent made free—all these programs taken together are a deliberate inflationary strategy that is taking us straight down the road to a "Great Depression." It is a road to a "black market" and "shadow business" economy, a road to a new totalitarian-Mafia serfdom.

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Transition and the Privatization Problem

Jan Winiecki

The real privatization problem in economies trying to make the transition from plan to market is to find a way to privatize that is both economically efficient and politically acceptable. In this paper, I will examine the privatization problem by considering (a) attempts to date in the USSR to privatize (or rather "denationalize") the economy and the futility of those approaches, (b) options that would be both efficient and acceptable, and (c) the role of foreign investment in the privatization process.

Soviet Attempts at Privatization: Reluctant Fumbling

In Soviet discussions and officially promulgated measures, marketization has taken precedence over privatization. This official position on markets and property is understandable: The Motherland of "real socialism" can (in theory at least) accept the market as it did in the time of Lenin's "New Economic Policy," but to accept private property would be an open admission that the whole economic history of communism has been a costly mistake. Therefore, the acceptance of a private property–based economy is—not unexpectedly—the last line of defense of the old order.

Under the circumstances, steps taken so far range from marginally important to misnomers to costly nonsenses. If evaluated together, they leave the impression of a package dictated by ideological prejudices and ignorance.

The development of the new cooperative sector has been widely regarded as a substitute for privatization proper. Cooperatives are a well-known alternative to private ownership. In the West, where the

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cooperative sector has a long history, cooperatives never achieved much in terms of their competitive position vis-à-vis private firms. Even the most sympathetic analysts relegate cooperatives to the margin of economic activity (see Wiles 1977).

It is doubtful whether cooperatives in the USSR will face a different future once private ownership—in its variety of forms—is allowed to compete. Thus, cooperatives can be safely relegated to the margin of any future ownership structure of the USSR economy.

Another development initiated in the second part of the 1980s is leasing. If cooperatives are a solution of little more than marginal usefulness, leasing of state enterprises to workers' collectives is a costly non-solution. Both cooperatives and leasing have been dictated by attempts to stay within a range of collective-based ownership solutions.

Leasing in agriculture is a solution with an even longer history than that of cooperatives. Leasing has been used since the Middle Ages, but it has all but disappeared in the West. The fact that private ownership dominates the agricultural sector points unmistakeably to the inferiority of leasing as an ownership form. Leasing of land in agriculture has its well-known disadvantages: for example, the need to protect land against premature depreciation caused by the leaseholder's careless treatment.[1]

Leasing is perhaps worth serious consideration with respect to the denationalization of *agricultural* assets. But leasing *industrial* assets (factories) to workers' collectives is an exercise in wastefulness of staggering magnitude. Transaction costs in supervising whether proper care is taken by a leaseholder with respect to leased land (and a few other assets) are trivial compared with the enormous transaction costs potentially involved in the monitoring of industrial enterprises that embody a highly complex set of assets. Huge bureaucracies would have to be maintained and there would be little prospect for successful monitoring of enterprise performance given the information assymetry between supervisory state agencies and enterprises.[2] The room for shirking and opportunistic behavior would be enormous (see Jensen and Meckling 1976).

A lease to a collective numbering hundreds or thousands of workers would create the need for an extensive bureaucracy either paid by the workers' collective or chosen from among the workers to

[1]For a general discussion, Eggertsson (1990 and the literature quoted therein).

[2]It should be kept in mind that it is precisely this asymetry that leaves hierarchical bureaucracies of a centrally planned economy at the mercy of state enterprises as far as supervision is concerned.

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control opportunistic behavior of co-leaseholders. Leasing to collectives of employees would, thus, generate two layers of agency cost—one at the state level and one at the enterprise level—and possibly result in higher transaction costs than in the case of state ownership pure and simple.

Finally, the Soviets have discussed the possibility of issuing shares by state-owned enterprises. These "shares," however, do not give owners the right to anything more than sharing in the profits of a given enterprise; they are little more than bonds with variable interest paid to their holders. The structure of shareholding does not affect the ownership rights, which remain in the hands of the state.

Consequently, at this point, it seems clear that no privatization in the narrow sense of the word—that is, turning state or other collectively owned assets into private hands—has been occurring in the USSR. In fact, no laws laying down the rules in this respect have been devised, let alone passed by the legislatures.

Privatization Alternatives

If privatization of state assets is to be seriously envisaged, it should be preceded by a thorough evaluation of goals and means through which these goals are to be realized. At the most general level, the goal of privatization is to raise the level of efficiency of the national economy. This general statement, however, is not sufficient to move from the goals stage to the means stage of the evaluation.

As discussions in post-Soviet-type economies such as Poland tend to show, the acceptance of the foregoing may hide more than it reveals. For example, various left-leaning politicians and economists tend to give support to the market economy and even to private ownership in the form of employee share ownership but not to concentrated ownership, for example, to capitalists. Yet it is not some abstract "market economy" that has proved to be the most efficient economic system; rather, it is the capitalist market economy, the one with the thriving capitalist class. As far as investment behavior is concerned, capitalists (people who take capital risk) behave more efficiently than those for whom income from capital (dividends from a few shares held) is a supplement only to income from work. Thus, the acceptance of the efficiency goal of privatization entails the acceptance of the rise of a capitalist class. This rise can be generated in many ways, including privatization.

Another goal of privatization may be the creation of dispersed ownership or "people's capitalism." This goal is generally compatible with efficiency. After all, even owning a few stock shares may

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make people aware of the relation between enterprise performance and shareholder worth. An efficiency-reinforcing side effect of share ownership is a greater acceptance of the "rules of the game" that underlie a market economy.

Privatization may also seek the improvement of public finances, such as the reduction of a budget deficit. Given the size of the Soviet Union's budget deficit, short-term considerations of balancing the budget may prevail over long-term considerations of efficiency. Since concentration on improving public finances affects the choice of the means of privatization (as will be shown below), this approach should be avoided.

The choice of means is no less crucial because certain means are compatible only with some goals. For example, if one focuses on the importance of reducing the budget deficit, then one must exclude all means of privatization that envisage free distribution of shares. In such a case, only two paths are open for privatization: (1) the sale of whole enterprises to individuals or groups of individuals or (2) the sale of shares of these enterprises, transformed into joint-stock companies, to the general public. Given the poverty of the population (and not the absence of a capital market), the sale of shares to the population is an approach that extends the process of privatization into the indefinite future. It took Britain's conservative government 11 years to privatize only a handful of state-owned enterprises, comprising about 10 percent of industrial assets. How long would it take to privatize the entire Soviet economy in the same manner? And, let it be added, in the absence of well-developed British financial markets.

The dire need to raise the level of efficiency of the national economy suggests that sale of shares to the general public is a means that will prolong the inefficiency of the Soviet economy by maintaining the dominance of the state sector for decades to come.

The short history of post-Soviet-type economies is also telling in this respect. In Poland the present government has been keen on privatizing along the "classical" British lines. However, after nine months of internal wranglings and pressures from outside, the government has changed its tune and started talking about "accelerated" privatization, that is, one involving the free distribution of assets in one way or another (see "Poland" 1990). In Czechoslovakia government officials responsible for privatization always have been aware of the futility of decades-long privatization through share sales (see Triska 1990). In Hungary the new government has not declared its preferences, but many Hungarian experts have pronounced themselves against free distribution (see Kornai 1990).

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If British-style sale of state assets in the form of shares to the general public is not a realistic approach for Soviet-type economies, what options are left to choose from? First, it should be said that a mix of measures is better than a single option. Thus, privatization should start with the offer of sale of small enterprises employing, say, fewer than 100 or 200 persons (as suggested, for example, in Beksiak et al. 1989) to anybody willing to buy them. However, since the absence of a legitimate private sector means that potential buyers may come from black-market operators and the ruling nomenklatura, this option may be less politically acceptable than in Poland or Hungary where the private sector existed for quite some time and expanded recently.

Those who favor accelerated privatization differ with regard to the method of privatization. There are those who prefer free distribution to the entire population (along the lines suggested by Friedman 1976 and Brittan 1984) and those who prefer free distribution to the workers.

Employee share ownership is now pressed strongly in Poland by the left. But even employee share ownership has certain disadvantages that make it less efficient relative to the classical capitalist firm. Employee-owned firms tend to bypass financial markets and, therefore, reduce the efficiency of resource allocation. There are other disadvantages of that solution as well (for example, innovation-related ones).

Employee ownership is not only economically less efficient but also socially inequitable. As pointed out by an old adage, the slogan "mines to the miners, steel mills to the steel-makers" means also "dirt to the dirt-collectors." Obviously, employees in viable capital-intensive enterprises get a lot; those in labor-intensive ones get little; while those working in education, public health, and administration get nothing at all.

Free distribution of shares to the whole population is devoid of such economic and social disadvantages. However, it is much more complicated because wide dispersion of ownership means that the agency costs of controlling managers will be very high (Winiecki 1990a). Broadly distributed ownership, therefore, will require financial institutions, and considerable time may pass before owners concentrate enough shares to control managers.

Janusz Beksiak et al. (1990) have suggested a combination of alternative privatization measures. At the start, 20 percent of the shares would be distributed to employees, and only those shares would have voting rights. The remaining 80 percent of the shares would be controlled by the state, which would receive only the right to

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dividends. The state would have no right to intervene in the affairs of the enterprises. Voting rights would attach to state shares only after privatization through sale or free distribution. Owners would be able to control managers from the very start through the board of directors elected by employees/shareholders. Eventually, the stock market would allow ownership to be concentrated; a controlling group from outside the firm's work force would emerge. In the interim, however, control over the management would be ensured. This solution has some negative consequences (see Beksiak and Winiecki 1990), but I think they are smaller than those of alternative solutions to the privatization problem.

In choosing the method of privatization, one must consider the politics of privatization. Privatization is not only an economic issue but also a major political issue. As such, privatization is subject to all the rules of a political game. And the first such rule is that if one wants to push through a certain solution, then one should start making allies. It is easy to point out that "people's capitalism" may win the acceptance of the general public, but in impoverished societies—as those in Eastern Europe—that may be less easy than in the West.

From a political perspective, therefore, free distribution of shares is the best means of privatization since it has the best chance of winning support from the public. Employees of large, capital-intensive enterprises, of course, will often be among those pressing for free distribution to workers rather than for broad-based distribution. But their claim may be countered by appealing to those who will find themselves at a disadvantage if such an option is to prevail. In any case it is advisable to weigh the political balance of power before deciding on the method of privatization.

Some Important Caveats

While we look for the best way to privatize state assets in the Soviet- or post-Soviet-type economy, there are quite a few pitfalls besides those associated with British-style privatization. Those pitfalls will be my main concern in this section of the paper.

The first pitfall is the fascination with state holding companies as a solution to the problem of privatizing large Soviet enterprises. In my view, state holding companies run by managers who are state appointees would be no more efficient than the present state-owned enterprises—and for the same reasons. Without private owners the managers of state holding companies would have the same freedom to pursue goals, other than profitability, as present Soviet managers.

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Comparisons with Western state holding companies are misleading. The fact that Western holding companies perform only slightly worse than comparable private firms stems from the fact that Western holding companies are forced to compete with predominantly private firms in the open market. Once a holding company becomes a norm for large enterprises, the environment changes for the worse. Competitive standards will not be maintained or—as in the Soviet case—will not emerge.

Soviet-type economies are characterized by giant enterprises and by a very weak network of small subcontractors. This industrial structure is much less flexible and less efficient than an economy where the size structure of firms follows a more normal pattern. However, the existence of large firms should not be seen as a deterrent to privatization. Poland, Hungary, and Czechoslovakia all have embarked on privatization from an industrial structure similar to that of the Soviet Union. Size is not a problem in itself.

There are two ways of improving the size structure of a Soviet-type economy. The first is "privatization from below," that is, the creation of a legal framework that allows private enterprises to emerge with a minimum of paperwork. Once the legal framework is in place, an institutional framework supporting the expansion of the private sector should be established. The second (complementary) way is through government fiat. There are some obvious cases where giant enterprises were created for the convenience of central planners, and there are no technological or other economic reasons for their continued existence. These enterprises may be broken up by decree (as was done in Hungary).

But there is another, again complementary, way of affecting the size structure of the economy—"from above." Bureaucratic knowledge is always limited, so it is better to give economic units within existing state enterprises the right to become independent enterprises and, subsequently, to be privatized. This right should be given at a preliminary stage of the agreed-upon privatization method(s).

Moreover, it is a known feature of a Soviet-type economy that state enterprises tried to be as self-sufficient as possible under the conditions of supply uncertainty and soft-budget constraint (Winiecki 1988). As a result, these enterprises have a lot of specialized units that are not related to their production profile. Many of these could also become small- or medium-sized firms in their own right and serve a variety of customers.

Another pitfall, related to the fascination with form without regard for substance (as in the case of state holding companies), is what I have called "playing at the stock market" (Winiecki 1990b). It is

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possible that those who prefer to maintain the dominance of state ownership—through state holding companies or any similar device—will, nonetheless, try to create the paraphernalia of the market economy. This effort could result in attempts to transform state-owned enterprises into state-owned, joint-stock companies, which would be allowed to participate in the newly established stock market.

Since bureaucrats appointed to run state holding companies or other state-owned constructs risk no capital of their own, their stock market behavior must differ from that of real private firms. There is a world of difference between the shareholder who uses his or her own knowledge, or hires a specialist to play the stockmarket with his or her own money, and the bureaucrat who risks somebody else's money in the game. In such circumstances nearly everything may look attractive, but the result would be overinvestment and disequilibrium as in the past. The stock market with players who are not penalized for failure by losing their own money is a sham—and a destabilizing one at that.

Another pitfall is to believe that privatization solves all problems. Well-assigned property rights are crucial for the efficient performance of the economy but other conditions, such as competition, also matter. Private monopoly is somewhat better than state monopoly because it is not protected by the power of the state, but it is not the best solution.

In some areas competition from abroad, which comes with the opening of the economy to the outside world, will put pressure on domestic monopolies (as in the case of tradeable goods). But there are areas where domestic competition will be increasing very slowly while foreign competition will be absent. In such areas special measures combined with privatization should be applied.

As an example, the average construction firm in the United States employs 10 to 12 people compared with over 700 people in Poland, and probably even more in the Soviet Union. Thus, in Soviet-type economies, regional construction markets are dominated by monopolists or oligopolists dictating their conditions to their clients. In this sector a well-designed way of breaking up these giants should be combined with privatization.

Another example is transportation in the retail and wholesale trade sectors. Given the bureaucratic convenience of centralization, all post-Soviet-type economies usually have just one transport enterprise for the whole retail trade sector in a city or locality. Thus, even the privatization of shops would not be sufficient for the healthy development of that sector, since small shopkeepers would face the

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strong monopolist supplier of transport services for quite some time and would distort the pattern of profitability in that sector. Cases such as these abound.

A final pitfall is that of underestimating the role of the time factor. Reformers tend to forget that even if it looks more efficient to undertake some measures in a certain sequence, reformers will be forced to act differently because of the pressure of time. The most often-harbored illusion is that it is possible to design, legislate, and implement privatization before stabilizing and liberalizing the economy. It is argued that the economy would adjust better to new, market-type conditions if it already were privatized. Accordingly, the costs of transition will be lower.

However, decisionmakers rarely if ever have all the time they would like to have. Transition to the market system is usually attempted under the conditions of quite large and growing disequilibrium. Continuation of past trends may cost more than starting stabilization, liberalization, and privatization almost simultaneously. The situation in all East European countries has not been the same in this respect. Poland and Czechoslovakia are contrasting examples. New governments took over at the time of deep and growing disequilibrium and accelerating inflation, which toward the end of the year bordered on hyperinflation. It was obvious that no systemic change would be successful without simultaneous stabilization of the economy.

Therefore, all aspects of change had to be tackled at once: stabilization and liberalization coupled with the beginning of privatization and demonopolization. (The fact that the Polish government failed to tackle privatization and demonopolization properly is an error different from that of wrongly sequencing transition measures.) Czechoslovakia has been displaying a much lower degree of disequilibrium and consequently could afford some preliminary attempts at improving the structure of the economy before stabilization and liberalization. But given the scale of disequilibrium in the USSR, any room for maneuver in this respect seems to be almost as narrow as it was in Poland at the end of 1989.

The Role of Foreign Investment in the Transition Process

There has been and still is a widespread belief among decision-makers that foreign investment is likely to bring an important positive contribution to the transition from a Soviet-type to a market-type economy. Another belief is that a law on foreign investment that

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offers generous incentives will encourage foreign investment, improve industrial structure, improve product quality, and increase hard currency reserves. Such an outcome, however, is highly unlikely. I do not mean that foreign investment is not beneficial for a host country: On the contrary, it undoubtedly is. What I mean is something usually overlooked by those who do not study the subject thoroughly.

It should be realized that foreign investment usually comes in significant quantity only when liberalization has already taken place and the economy displays signs of stability. Currency convertibility and a stable legal framework are especially valued by potential investors (much more so than incentives that can be changed overnight in the unstable regulatory environment). Therefore, foreign investment should be seen as a sign of success of the transition to a more liberal market order that has already taken place, rather than as an expression of hope in the transition that has barely begun.

In small, post-Soviet-type economies (such as Poland, Czechoslovakia, and Hungary) or in the USSR, large-scale foreign investment in manufacturing is highly unlikely at an early date. Foreign investment is not a substitute for a given country's own transition effort. Rather, is a complement—and one coming at later rather than earlier stages of the transition to the market. Moreover, what is true of direct foreign investment is even more true with respect to buying into domestic joint-stock companies where a relatively smoothly functioning stock market is another requirement.

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The Law of the Microcosm and the End of Socialism

George Gilder

The Information Revolution

Every era achieves a cultural pinnacle. In the Middle Ages it was probably the giant cathedral, whether Gothic or Byzantine. Wrought of rock and sand and glass, these cathedrals stand today as a cultural and religious epitome, a beacon of faith and aspiration reaching forth over the centuries—issuing a reproach to most of the architecture and art of the current epoch.

Nonetheless, our own age, I believe, has summoned a monument of aspiration and faith, devotion, diligence, and art as formidable as the great cathedrals of the past.

The cathedral of the 20th century is the microchip, a tiny computer inscribed on a small piece of semiconductor material. Like the medieval cathedrals, the microchip is wrought of the commonest elements in the earth, being earth itself. But seen through a microscope, that semiconductor shape emerges with the opalescent symmetry of a cathedral window.

I would sum it up in a vision of sand and glass. The sand is the substance of microelectronics. It comes in the form of a silicon sliver the size of a thumbnail that bears a pattern of wires and logic as complex as a street map of America, switching traffic in trillionths of seconds. At the heart of a microchip is the microswitch: the transistor. Twenty years ago transistors cost $7 dollars apiece and were plugged into circuit boards one at a time by hand. Today far better, faster, and more useful transistors cost a few ten-thousandths of a cent.

Current chips contain as many as 20 million transistors. Scores can be placed not on the head of a pin but on the point of a pin. Switched

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in trillionths of seconds, these devices transcend all the normal constraints of time and space. Their development is by far the most important event of the current era.

The microchip of sand, however, joins with another amazing technology made of glass. The glass in the vision is so pure that if it were a window, you could see through miles. But it comes in fiber-optic threads the width of a human hair and as long as the rails to Leningrad. It is fed by laser diodes the size of a grain of salt and brighter than the sun. Today these threads flash information between the East Coast of America and Chicago at a pace of 8.6 gigabits a second: a thousand bibles a second. This technology represents a vast leap ahead of the copper wires that transmit most phone calls around the globe. For example, the U.S. Congress maintains a library holding all the publications of the nation over the last 100 years. Using copper wires would take 500 years to transmit the contents of the Library of Congress. Using fiber-optic threads would take just eight hours.

As this technology moves into homes and offices over the next decade, it will hugely enhance the powers of individuals to send and receive communications of all kinds, from movies and other digital video products to whole libraries of data and text. In the process it will replace the dumb television terminal with a telecomputer that can not only receive but also shape and send digital data and images.

As fast as fiber-optic technology is advancing, however, chip technology is keeping pace. Within the next 10 years, it will be possible to put as many as one billion transistors on a single sliver of silicon. One billion transistors is equivalent to the computing resources of perhaps 20 of the world's largest supercomputers, whether Crays in the United States or Elbus machines in the Soviet Union. Within the next 10 years or so, this computer power will be inscribed on a single chip that will cost less than $100 dollars to manufacture. Such an advance will mean approximately a million-fold rise in the cost-effectiveness of computing in 10 years.

Together these two technologies will create a global ganglion of computers and cables, a worldwide web of glass and light and sand that leaves all history in its wake. For good or ill, this technology will shape the future of all nations through the 21st century.

A New Economic Structure

The rise of these miraculous tools, I believe, both necessitates a radical change in the economic structure of the USSR and makes such a change possible. These microelectronic tools will allow the Soviet Union to move toward capitalism without suffering the pains

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and setbacks that economists often prescribe. However, the use of these new tools utterly requires the abandonment of all dreams of a centralized economy.

The Wealth of Knowledge

Mikhail Gorbachev pronounced a crucial insight regarding this new era. He pointed to the most valuable resource of the age. He did not mention oil or gas or gold, missiles or nuclear power. Instead he declared: "In the age of information sciences, the most valuable asset is knowledge, which is a creation of human imagination and creativity. We were among the last to comprehend this truth and we will be paying for this oversight for many years to come."

Gorbachev may be too pessimistic. The Soviet Union is full of the most valuable asset of the information age, full of well-trained and resourceful men and women. It faces no inherently difficult problem of transition. It merely faces the challenge of liberating its crucial resources of knowledge, now incarcerated in a million mazes of bureaucracy.

The Spirit of Enterprise

T. J. Rodgers of Cypress Semiconductor, one of the leading American microchip entrepreneurs, recently discovered how rich Russia is in the crucial resources of this new age. He visited the USSR in the summer of 1990 intent on licensing a graphics chip design. He expected to find the Soviet Union far behind the United States in semiconductors. In many ways he was right. In manufacturing and selling chips, the Soviet Union is indeed far behind. Compared to state-of-the-art American chips, Soviet devices are big and slow. But in a crucial way, T. J. discovered that he had greatly underestimated the Soviets.

Rodgers found that the Soviet failure to develop advanced hardware had induced great creativity in computer architecture and software. The absence of leading edge computer technology impelled Soviet engineers to an early mastery of the algorithms of parallel processing: using many low-performance microprocessors in parallel to emulate the most-advanced single processors. Soviet computer architects and chip designers, Rodgers discovered, emerged from their crucible of privation as some of the best in the world.

Some Americans making such a discovery would have hastened back to the Pentagon to report the terrible news of a new Soviet threat in microelectronics. Some American businessmen might have petitioned the government for new subsidies and supports to help keep pace with the Soviet designs. Even in America, many people

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see the world as a zero sum game, with every gain for one country—or company—a loss for someone else. Prevailing through the centuries, this attitude—the view that the success of others is a threat rather than an opportunity—has blighted most of human history. The view that creators of wealth somehow oppress the poor is the most crippling prejudice of Marxism. T. J. Rodgers, however, is embued with a different spirit: the spirit of enterprise.

Being an entrepreneur, T. J. on the spot decided to buy licenses to all the salable technologies he found. He bought licenses for nine chip designs from such Soviet firms as INTEREVM, Mikron, Angstrem, Progress, and Elas. He launched a major computer project with a Soviet team. Entitled "Mir," it will be executed by a 50-man team in the USSR. Today some 15 leading Soviet engineers are working at Cypress in the United States.

Gains from Trade

T. J. was thrilled with the computer people he met in the Soviet Union. As an entrepreneur he could launch mutual projects with them almost immediately. Did he exploit the Soviet designers he dealt with? No. They all will gain hard currency royalties from any chips sold in the United States. Some of their designs were too complex even to be manufactured in the Soviet Union. They will have their chips produced on the best semiconductor production lines in the world. They will gain financially, and they will gain from the experience of having their ideas realized in hardware and sold widely to customers.

The Soviet Union will gain technologies that were previously unavailable to them and markets that were previously beyond their reach. Thus they will gain guidance about where to focus future efforts. The Soviet computer experts who dealt with T. J. Rodgers came away as big winners.

How about T. J.? He gained access to the most valuable resource of the information age: human creativity and imagination. He extended his product line into the important fields of digital signal processing and image processing, which his company had previously neglected. He won the rights to the output of an important new computer product. He gained entrance to what will be a tremendous new market for high technology devices. He too was a big winner in the Soviet Union.

That is the key secret of capitalism: win-win rivalry. Everybody wins; no one is exploited. Because every deal is voluntary, both sides gain; every transaction is a positive sum. If anyone feels unsatisfied with the terms, the deal cannot go through. Since each side improves

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its position through the transaction, the very process of free capitalist trading ensures that national wealth increases with every exchange.

Gross national product (GNP) rises even without the creation of any new product. The free market enhances the value of all the production of the nation by ensuring that it will go the people who want it most and can use it best.

Until T. J. showed up in Zelenograd, many of the great chip designs and computer architectures of the USSR were valueless because they could not find customers or manufacturers. His entrepreneurial vision lent value to intellectual properties that were valueless in the Soviet economy.

The Use of Knowledge under Socialism and Capitalism

In contrast to chip designs deemed worthless in the USSR, T. J. also visited a great center of wealth and power as judged by Soviet authorities. He visited the office of the man he said "has the worst job in Moscow." That is saying a lot. That man is a noted physicist named Yuri Pavlov. He does not sweep the streets or clean the public toilets. His job is "General Director of Moscow City Council Scientific Development Conglomerate for Automated Control Systems." He runs Moscow's governmental computer center.

The wonders of central planning mean Yuri has to plan the movement of bread and milk. He tries to make the lines shorter. He also keeps track of health care, drug prescriptions, retirement payments, water bills, apartment rents and allocations, and a long list of other services for nine million people.

Pavlov is a man of great relative wealth and power in the Soviet Union. He commands arrays of seemingly valuable computers. He helps rule the lives of millions. Unlike the chip designs deemed worthless in the USSR, Pavlov's establishment is supremely valuable in the planned economy.

In a market system, however, all Pavlov's panoply of powers and machines is less than worthless. The old IBM compatible computers he uses could hardly be sold as scrap in the United States. The work he does is irrelevant in an economy where economic planning is performed voluntarily by millions of individuals.

It is often said that the Soviet Union cannot prosper without huge inflows of capital from the outside world. That is an absurd assumption. The Soviet Union is already glutted with capital: roads, factories, weapons, mines, tractors, schools. For decades, the Soviet Union has invested a hugely greater proportion of its wealth than the United

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States. Communist systems are nearly always awash with useless capital. But without freedom, capital is blind and sterile.

In a capitalist system, you do not need new capital to create wealth. Freedom in itself creates wealth just as T. J. created new wealth at Zelenograd. By allowing the perpetuation of economic planning, outside capital may even reduce the real wealth of Russia. It may plunge the real capital of the nation—its creative citizens—into the darkness of production without free customers.

Freedom means the right to fail. The key reason the U.S. economy is more successful than the Soviet economy is that the United States allows more failure. U.S. scientists and engineers outproduce Soviet scientists and engineers not because they are more numerous or better trained or more talented. In fact, there are many times more highly trained scientists and engineers in the USSR than in the United States, and Soviet students outperform American students on international tests.

U.S. scientists and engineers create more value because they collaborate with millions in the marketplace around the world. Soviet scientists and engineers collaborate only with each other and their political bosses. U.S. scientists and entrepreneurs can prevail because they can fail.

Bankruptcies play the same role in economic progress that falsification plays in the progress of ideas. The eminent philosopher of science Karl Popper identifies a valid scientific proposition chiefly by whether it is stated in a form in which it could possibly be disproved or rejected. If a theory—such as that people born in August under the sign of Leo tend to be temperamental—is too general or flexible to be proven wrong, it is incapable of generating new knowledge. Similarly, if an economic plan cannot be rejected by the marketplace, it cannot generate new value.

Every new business, however, provides an entrepreneurial test of a new idea. Unlike a national plan, a business plan is falsifiable. Because it can fail, it can also generate new knowledge. In fact, entrepreneurs often learn more from their failures than from their successes.

By the very process of acquiring profits, entrepreneurs learn how to use them. By the very process of building businesses, entrepreneurs gain the discipline to avoid waste and the knowledge to see value. By the process of creating and responding to markets, entrepreneurs orient their lives toward the service of others. Entrepreneurs who hoard their wealth or seek governmental protection from rivals or revel in vain consumption or retreat to selfish isolation betray the very essence of their role and responsibility in the world.

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To that degree, they are no longer entrepreneurs or capitalists but relics of the feudal and static societies of the precapitalist era.

Every capitalist investment has a dual yield: a financial profit and an epistemological profit. One without the other is barren. Economies progress when the process of investment is informed by the results of previous investment. Entrepreneurs like T. J. Rodgers spread wealth because they constantly accumulate new knowledge by risking failure. This new knowledge is the most crucial capital they wield.

For many years, Marxists have believed that they could solve the knowledge problem of socialism through the creation of ever-larger knowledge machines: computers. Giant computers could simulate markets and thus render freedom unnecessary and obsolete.

I believe, however, that it is the computer that makes communism obsolete. The microchip may indeed offer the solution to the problem of socialist bureaucracy. But it is also the dissolution of socialism and all other centralized systems.

The Problem of Complexity

The key problem of the planned economy is the explosion of complexity. In the planned economy only the bureaucrats can plan. But their plans inevitably break down in the nearly infinite complexities of a large economy. In a free economy, all citizens and businesses can make plans. Because individual businesses face manageable complexities, they can actually carry out their plans. The paradox of the planned economy is that it prohibits all practical planning.

The Law of the Macrocosm

This problem can be summed up as the law of the macrocosm or the law of complexity. It shows that complexity rises by the square of the number of entities to be organized—whether phones in a network, chips on printed circuit boards, or prices and quantities in an urban economy. This law even confounds computations in physics, where the so-called many-body problem afflicts all analysis of relations between large numbers of entities.

Arno Penzias, the Nobel laureate physicist, explains the problem in terms of the impact of an additional child arriving at a party. The noise level does not rise by the increment of one more child; it rises exponentially in proportion to the additional child and all the other children he may shout at and interact with. This is another form of the many-body (and vocal-chord) problem. That is, it is an example of the law of the macrocosm.

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The Law of the Microcosm

In the microcosm of silicon chips, however, a completely different law applies: the law of the microcosm. On silicon, it is not complexity but efficiency that rises by the square of the number of entities to be organized. The more transistors crammed on each microchip, the cheaper, faster, cooler, more powerful, and more valuable they are. This relationship is measured in the industry as the power-delay product, relating the power consumption (and heat) to the speed of operation of a microelectronic device.

On individual microchips the power-delay product improves exponentially with the increase in the number of transistors and thus the closeness they are packed together. As electrons moving in a transistor approach their mean free path—the distance they can travel without colliding with the structure of the silicon crystal—they move faster and more efficiently. It is as if a million more children arrived at the party and the noise level went down.

These gains in efficiency, however, apply only on individual chips. You begin combining lots of chips together and the law of complexity takes hold again. That is why the Elbus strategy for saving socialism —the big computer dream—will inevitably fail. All computers will eventually become single chip systems, basically equal in power and cheap enough for anyone to buy. Any top-down structure of organization—any hierarchy—will eventually collapse into a heterarchy, where equal processors, or individuals, communicate with one another on an essentially equal basis.

Once again, this is not an optional outcome; it is inherent in the very physics of computation. As chips rise toward a billion transistors each, their processing power will rise even faster. But the communications power from the chip, by contrast, will eke up slowly; it will depend on the circumference or in some cases on the area of the chip. Thus the premium on single chip systems will steadily increase. The penalty for master slave systems will rise acutely.

What is happening is the overthrow of the previous relationship between the cost of wires and the cost of switches. Wires are the communications medium between chips, and switches are the transistors that give the computer logical powers. When wires are cheap and switches expensive, it makes sense to centralize. It pays to run a few more wires to an expensive central processing unit dominated by switches. This was the case at the beginning of the computer era when switches were fragile and expensive vacuum tubes. Today, however, switches are virtually free—infinitesimal transistors on a chip—while wires are relatively expensive. Under these conditions, it pays to distribute intelligence on single chips.

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The End of Socialism

The obsolescence of the big computer is already evident. For example, in 1977 nearly 100 percent of all the computer power in the world was commanded by large machines with dumb terminals attached. Just 13 years later, that figure had dropped to well under 1 percent. There are now over 100 million personal computers in the world, and they command virtually all the globe's computer power.

It is this change that dooms socialism. It is this change that permanently overthrows Marxism. Although Marx was wrong about many things, he did sense a crucial fact about the past industrial order. In the past, machines were hostile to human values. Factories worked best when individual workers adapted themselves to the machine. Industrial analysts would actually measure the movements of workers and attempt to adjust them to the requirements of the equipment they used. Even in free-market economies, the factory or assembly line tended to be a top-down hierarchy.

This system resulted in huge gains of human productivity. But whether in the East or West, it was deeply inimical to the nature of human beings. Human beings are far more like chips than like assembly lines. We have the most powerful processors in the world between our ears. Two human eyes, for example, can do more image processing than all the supercomputers in the world put together. But as in the case of chips, our communications power is strictly limited. About 50 bits per second is the estimate of the experts.

The chemist, Michael Polanyi, has explained the effects of this relationship. It means that the bulk of human learning is tacit knowledge: It is literally incommunicable. For example, there is no way to explain how an individual reaches out and picks up a glass of water and brings it to his lips. Most of what we know about our jobs is this kind of tacit knowledge. Although the industrial era enhanced the productive power of human beings by raising their physical strength, this gain came at the cost of a loss of tacit knowledge.

The nature of human beings means that an organization functions best when individuals can be coupled as closely as possible to specific problems. Leaders can offer general goals and directions. But specific guidance and controls will cost far more in tacit learning than they will gain in efficiency. Workers must have common visions but not detailed supervision. Top-down bureaucracy, private or public, obliterates the crucial mental powers of human beings that elevate us above the apes and give us mastery of the world.

The microchip is the first technology that accords fully with the nature of human beings as thinking creatures. Favoring heterarchy over hierarchy, it overthrows all top-down systems.

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As the chip reorganizes industry and commerce so also will it reorganize the powers of states and nations. The law of the microcosm subverts any attempt to capture, intimidate, confine, or overwhelm the exertions of mind by the tyranny of matter.

The mobility and ascendancy of mind among all the forms of capital deeply undermines the power of the state. Quantum technology devalues what the state is good at controlling—material resources, geographic ties, physical wealth. Quantum technology exalts the one domain the state can never finally reach or even read: mind. Thus the move from the industrial era to the quantum era takes the world from a technology of control to a technology of freedom.

The New Industrial Revolution

The most evident effect of the change is a sharp decline in the value of natural resources. The first industrial revolution vastly increased the value of materials. All the dirt, rock, and gunk that had been ignored for centuries suddenly acquired worth in the age of mass manufacturing. The new industrial revolution is a revolution of mind over matter, and it is rapidly returning what used to be called "precious natural resources" to their previous natural value as dirt, rocks, and gunk.

The use of steel, coal, oil, and other materials is plummeting as a share of value added in the economy. As a symbol of the shift, consider two smelting processes. When smelting iron, you banish silicon in the slag as dirt; when "smelting" silicon, you get rid of the iron as conductive waste. A silicon chip is less than 2 percent raw materials. A few pounds of fiber-optic cable, also made essentially of sand, will soon carry as much information as a ton of copper. A single satellite now displaces many tons of copper wire.

This change has transformed the very foundations of geopolitics. Raw materials have long constituted a leading reason and reward for military aggression. In the past, ownership of particular regions imparted great political and economic power. The balance of power in Europe depended in part on who controlled the coal and steel in the Ruhr Basin. The Ruhr Basin is now a European sink of government subsidies.

We live in an epoch when desert-bound Israel can use computerized farming to supply 80 percent of the cut flowers in some European markets and compete in selling avocados in Florida, when barren Japan can claim to be number one, and when tiny islands like Singapore and Hong Kong can far out-produce Argentina or Indonesia.

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To comprehend the change, consider a steel mill, the exemplary industry of the previous epoch: a huge manufacturing plant entrenched near iron and coal mines, anchored by a grid of railways and canals, and served by an army of regimented workers, all attended by an urban infrastructure of physical systems and services. At every step the steel mill can be regulated, taxed, and controlled by government.

Compare this massive array of measurable inputs and outputs to a person at a computer work station, with access to data bases around the world, designing microchips of a complexity exceeding the entire steel facility, to be manufactured from pattern generation tapes. Even the tape, the one physical manifestation of his product, has become optional. Without any fixed physical manifestation at all, the computer design can flow through the global ganglion into another computer attached to a production line anywhere in the world.

Even observers who comprehend the nature of information technology, however, often fail to understand its radical effect on international economics. The decline in the value of raw materials entails an equal decline in the value of geography. In an age when individuals can inscribe new worlds on grains of sand, particular territories are fast losing economic significance.

Not only are the natural resources under the ground rapidly declining in value, but the companies and capital above the ground can rapidly leave. Commanding a worldwide network of transport and communications, the modern business firm can send wealth flashing down fiber-optic cables and caroming off satellites at the speed of thought rather than of things.

Capital is no longer manacled to machines and places, nations and jurisdictions. Capital markets are now global and on line 24 hours a day. People—scientists, workers, and entrepreneurs—can leave at the speed of a 747, or even a Concorde. Companies can move in weeks. Ambitious persons need no longer stand still to be fleeced or exploited by bureaucrats. Geography has become economically trivial.

Empowering Individuals: A Microeconomics of Liberty

The global microcosm has permanently shifted the world balance of power in favor of entrepreneurs. Using the planetary utility, they can avoid most of the exactions of the state. Without their fully voluntary cooperation, a government cannot increase revenues,

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enhance military strength, provide for the public welfare, or gain economic clout.

This good news for individuals and entrepreneurs, however, is bad news for socialism. The state can dig iron or pump oil, mobilize manpower and manipulate currencies, tax and spend. The state can expropriate the means of production. But when it does, it will find that the most productive members of society—the entrepreneurs—will run for the daylight of liberty. One way or another, most of the time, the entrepreneurs take their money with them or send it on ahead. But always they take their minds, and knowledge is their crucial power.

Ideas are subjective events and always arise in individual minds and ultimately repose in them. The movement toward a quantum economy necessarily means a movement toward an economy of mind. Collective institutions will survive only to the extent that they can serve the individuals and families whom they comprise.

This is the age of the individual. Governments cannot take power by taking control or raising taxes, by mobilizing people or heaping up trade surpluses, or by seizing territory or stealing technology. By imperialism, protectionism, and mercantilism, nations eventually wither and weaken into third worldly stagnation.

In the modern world, the chief source of the new wealth of nations is free immigrants. Today nations have to earn power by attracting immigrants and by liberating their people, their workers, and their entrepreneurs.

The gains of the quantum era could yet be destroyed by some thug offering a final horrible holocaust to the Moloch of matter. But the logic of the technology, the logic of the microcosm, which is becoming the logic of history, runs the other way. History has capsized every prophecy of triumphant bureaucracy.

Rather than a New Industrial State, this era will disclose the new impotence of the state. Rather than the Revolt of the Masses under the leadership of demagogues, this era will see the revolt of the venturers against all forms of tyranny. Systems of national command and control will wither away. Systems of global emancipation will carry the day. The dismal science of the economics of aggregates—capital, labor, and land—will give way to a microeconomics of liberty. The beggar-thy-neighbor strategies of mercantilism—of trade as a weapon of the state—will collapse before the strategies of global wealth creation under the leadership of entrepreneurs.

The new technologies—themselves largely the creation of promethean individuals—completely transform the balance of power between the entrepreneur and the state. Inventive individuals have

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burst every link in the chain of constraints that once bound the entrepreneur and made him a servant of parliaments and kings. He is no longer entangled in territory, no longer manacled to land, capital, or nationality.

These developments are no special American monopoly. Indeed much of the benefit will be lost if only the United States and a few Asian capitalist countries follow the crucial lessons of the new technology. For the central lesson is that information technology is not a zero sum game to be won by some governmentally supported monopolist. Information technology constantly redistributes its own powers as it is used. The final and most flexible source and vessel of these powers is the individual human mind. The power of information always ultimately gravitates to individuals.

Conclusion

All the world will benefit from the increasing impotence of imperialism, mercantilism, and statism. In this new economy of freedom, Americans must hope for the prosperity and freedom of Russians and Chinese. We must celebrate the successes of Koreans and Japanese. We must hail the increasing wealth and power of the Third World. Depending on an altruistic spirit, the microcosm requires not only a technological renaissance but also a moral renewal. Following in the steps of T. J. Rodgers, all Americans will cheer the success of the Soviet Union in its great adventure of reform. Within the spiraling gains of capitalism, impelled by the spread of information technology subverting all tyrannies, there is room at the top for all.

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BOOK REVIEWS

Capitalism
Arthur Seldon
Cambridge, Mass.: Basil Blackwell, 1990, 419 pp.

For more than 30 years, Arthur Seldon has supervised and edited most of the publications of the Institute for Economic Affairs. Over most of those years, I have written some 15 articles or monographs for the Institute. And I can assert that Seldon has been by far the best editor I have ever encountered. This is largely because of his great respect for ideas, their coherence, and their expression. But also because of his unwavering courage in facing the facts, recognizing the fallacies of socialism, and acknowledging the faults but appreciating the marvelous beneficence of free-market capitalism.

It may be difficult for most of the readers of this review to imagine the intellectual climate when Arthur Seldon, along with Ralph (now Lord) Harris started a think tank (the Institute of Economic Affairs) devoted to exploring the ideas of liberal (in the European sense) institutions. The all-but-unanimous consensus was that planning—perhaps some form of "market socialism" in a welfare state—was the wave of the future. Khruschev had promised to bury capitalism and predicted that soon the Soviet Union would overtake the United States—"We are all planners (or Keynesians or socialists) now."

Undeterred, nay I would say egged on, by reproofs about the political impossibility of the ideas of a liberal society, Seldon has been quite fearless in his pursuit of the truth. At a conference some five years ago, I heard a distinguished Swedish economist reprove Seldon for his "extremism" in pursuit of market solutions; Arthur took it (rightly) as a compliment.

The present book is a more of a celebration rather than distillation of all those ideas. It is doubtful if anyone knows the literature on the history of the failures of socialism and the triumphs of capitalism better than the author. He draws his evidence from an amazingly broad field—from tombstone inscriptions for some 18th-century schoolteacher to illustrate that fee-paying private education was common, and from the literature of the Brontë sisters to show the efficacy of private competition. I suppose that most economists will claim that Seldon is still an absurd extremist. Yet this book appears at a time when socialism is seen universally to have been a sad and tragic failure—a failure that Arthur Seldon had

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always predicted. But Arthur's work is never done. He argues the case for not merely a limited state but for a *minimal state*. In his view, the liberals who believe in a limited state have far too long and complex an agenda for government for that agenda to be allowed.

Seldon (p. 219) sums up:

> The argument for democracy over dictatorship is the argument for capitalism over socialism. The real or supposed defects of capitalism—alternation of inflation and unemployment . . . extremes of wealth and poverty, monopoly . . . overcentralization, poor schooling . . . and much else—are not endemic; they are largely the results of overgovernment. . . . They can be removed. The real defects of socialism—suppressed unemployment and inflation, widespread privation and injustice . . . suppression of freedom in economic activity, political rights and cultural life, ingrained nepotism . . . and much else—are endemic. They are parts of the system; without them socialism is unworkable. In the end that is the case for imperfect but perfectible capitalism.

Although I have known Arthur and have been close to the IEA for more than 30 years, I must confess that most of the examples and illustrations of his argument were new to me. Together with his wife, Marjorie, Seldon often illuminates his argument with a telling anecdote of human behavior.

But, like capitalism itself, he is not perfect. One general criticism is that the book does not properly get to grips with the issue of democracy and capitalism, in spite of the excerpt above. A common question in the ex-Communist countries is: Can the reforms to a market economy be carried through with a democratic government? Seldon identifies the central fallacy that democracy is *sufficient* to ensure "popular sovereignty over government or economic life." Democratic tyranny is not an oxymoron; it has been and is a reality in many a sad state. But can a free market exist in a dictatorship? Seldon comes near the nub of the problem when he says: "Even with restricted political democracy, free markets could create the indispensable liberties required for the democratic control of resources." The bald truth is that a free-market economy has often been not only tolerated but actually promoted by dictators, despots, and colonial administrators. Perhaps the most remarkable example is that of Pinochet's Chile—a dramatic reform from Cuban communism to the most free and unfettered market economy in Latin America. The most striking example of tolerance is the astounding development of Guangzhou and much of South China. Capitalism is triumphing with growth rates of over 12 percent during the last decade. Yet the political repressions go on. A rather more long-lasting and, I think, decisive case is that of Hong Kong. No democracy was

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ever contemplated in that colony. It was ruled by colonial administrators—albeit with principles that would have delighted Adam Smith.

The question raised by the ex-Communists still remains: Is it *necessary* to have a dictatorship, however distasteful, in order to reform a Communist system? I wish I could confidently assert that a dictatorship was certainly not necessary, but I can find no warrant for such an assertion. The ramblings of our statesmen on this issue may well be a consequence of our "thinkers" being unwilling to face squarely an obvious dilemma.

Finally a grouse. In my view one of the great economists who pulled out a critical lynchpin from the facade of socialist thought was Nobel Laureate Ronald Coase—one of Seldon's teachers at the London School of Economics in the 1930s. In his magnificent article "The Problem of Social Cost," Coase (1960) showed that in a competitive free-market system, private costs are the same as social costs and that the market would internalize "externalities" if transactions costs are low. Seldon frequently refers to externalities and often rubbishes the arguments, usually non sequiturs, for government intervention or ownership. But I am at a loss to understand why he did not employ Coase's lethal weapons against such sophistries.

Unlike most books on economics these days, Arthur Seldon's book is a good read. Sometimes he charms, sometimes infuriates, but all for the good of the cause—Capitalism.

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Marxism and Workers' Self-Management: The Essential Tension
David L. Prychitko
New York: Greenwood Press, 1991, 153 pp.

David Prychitko defines the purpose of his book *Marxism and Workers' Self-Management: The Essential Tension* as follows:

> The crucial issue for the Yugoslavs, Gorbachevites, and other Marxists who hold out hope for decentralized, worker-managed socialism is whether the crisis of Yugoslav-style self-management resulted from poor practice and implementation in Yugoslavia, or whether it stems from a more fundamental problem of theory and system that goes all the way back to Marx himself.

The book has six chapters that explore this key issue.

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Chapter 1 offers a brief discussion of the utopian socialists and their influence on Marx. Prychitko makes an interesting point in this chapter about Marx's appreciation of the effects of the "age of science" on the intellectual community. According to Prychitko, Marx replaced the wishful thinking of the utopians with the concept of scientific socialism. As such, Marx was able to exploit the prevailing mood of his times, which was sympathetic toward market socialism.

In chapter 2, Prychitko takes issue with Roberts and Stephenson (1973) who argue, in what is still perhaps the best analysis of Marxism, that the elimination of commodity production and market exchange in socialism means that Marx considered scientific socialism to be centralized and hierarchical. By questioning this conclusion, Prychitko ends up giving too much credit to the so-called praxists and their interpretation of Marx. My conjecture is that the praxists' (most of them Yugoslavs and all of them hard-core Marxists) interpretation of Marx reflects their self-interest rather than Marx's analysis of social change. By interpreting Marx as a believer in a participatory economy and non-alienated socialist society, the praxists were able to provide the left-wing intellectuals in the West with a flow of exciting ideas for new social experiments and, at the same time, create a market for themselves in Western universities. For example, Prychitko quotes Mihailo Markovich, a leading Yugoslav praxist, as saying in 1974: "An essential condition of such fundamental human liberation is the abolition of any concentration of political and economic power in the hands of any particular social group" (p. 51).

Chapter 3 is a review of the literature on the never-ending search by social engineers for institutional arrangements that could replace private ownership and competitive markets without a major loss in efficiency. It is a good chapter and I have only two comments. First, Prychitko left out of his discussion an instructive event from the history of labor participation in the management of business firms. About 1848, the German parliament failed to pass legislation that was intended to create representation of workers in privately owned business firms. However, within a short period of time some provisions of that act were *voluntarily* implemented by a number of firms—the point being that in a private-property, free-exchange environment the owner(s) and his workers do not need law to make institutional arrangements that are mutually beneficial. Second, Prychitko wrote: "The contemporary debate has shifted to the interesting, though more narrow and *less fundamental*, problem of the self-managed firm's ability to realize appropriate and efficient incentives with respect to output, employment, and investment decisions" (p. 55, emphasis added). I think that the effects of self-management *institutions* on incentives and transaction costs are very fundamental for the study of self-managed socialism.

In chapters 4 and 5, Prychitko reviews the on-going debate over the self-managed enterprise and its viability. His discussion of all the various models of labor participation in the management of business firms is

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straightforward and correct but not as analytical as those of Jenson and Meckling (1979) and Milic Milovanovic (1990). First, a major problem with the works of Vanek, Horvat, Meade, and other proponents of self-managed socialism is that they do not clearly specify the basic institutional and contracting rights they have in mind. Thus, their models cannot identify incentives and transaction costs that are *specific* to self-managed socialism. Consequently, they ignore the behavioral implications of those specific transaction costs and incentives on the performance of the system. Second, Prychitko fails to draw some important implications from the fact that Vanek, Horvat, and other proponents of self-managed socialism have to search for and use various immunizing stratagems—most of which contain elements of private ownership—in order to deal with negative incentives and high transaction costs of self-managed socialism. But if one could improve the efficiency of labor-managed socialism by introducing elements of private ownership into the system, then it would appear that *full* ownership rights could do even more for that system.

In sum, while Prychitko's book is a well-written and useful account of the on-going debate on the viability of self-managed socialism, it fails to provide a convincing analysis of its stated purpose. Those who support self-managed socialism are eager to establish a difference between the "efficiency" of their models and the Yugoslav experience with self-management. In general, the failure of self-managed socialism in Yugoslavia is seen by them as a consequence of the Communist party's political monopoly and the size of the bureaucracy. That may or may not be the case. However, the analytical issue to be raised here is: Does labor-managed socialism require an effective political monopoly in order to protect self-managed firms from competition by other methods of organizing production? I do not think Prychitko has addressed that issue.

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The Economics of Apartheid
Stephen R. Lewis, Jr.
New York: Council on Foreign Relations Press, 1990, 196 pp.

Most writing about South Africa is little more than moral exhibitionism. Stephen R. Lewis spends only a sentence or two acknowledging the

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moral reprehensibility of apartheid, and then he moves on to more substantive issues.

In his first chapter, Lewis sets out to provide the reader with an outline of the origins of apartheid. Mine owners seeking to avoid higher wages as they competed to hire black workers formed noncompeting collusive hiring arrangements. These collusive hiring agreements were later reinforced by the 1911 Native Labor Regulation Act that made it a crime for blacks to break a labor contract. Meanwhile, white workers, who did not want to compete with low-wage blacks, sought protection through restrictive licensure laws and a Status Quo Agreement that set a limit on the number of blacks that could be hired in certain jobs. The mining companies' violations of agreement led to the 1922 Rand Rebellion, the most violent strike in South Africa's history. The government had to use troops, artillery, and aerial bombardment to end the strike, and in the process 300 whites were killed. The strike led to the downfall of the Smuts government and the rise of successive governments sworn to create and protect white privilege.

Lewis intends only to give a thumbnail sketch of the history of apartheid, but in doing so, he fails to even mention the magnitude of the task of creating white privilege. At nearly every turn, whites as businessmen, farmers, and consumers violated, contravened, and cheated on apartheid protections. They did so, not because they did not share the ideology of white supremacy, but because the higher profits and cheaper prices possible through cheating offered powerful inducements.

Chapters 2 and 3 contain a discussion of the growth and structure of the South African economy and its relation to the international community. Lewis presents statistics on sectoral growth, distribution of earnings over time by race, homeland GNPs, and many more facts useful to anyone trying to get an economic glimpse of South Africa. The extent to which foreign trade accounts for economic activity in South Africa is impressive and often surprising to those unfamiliar with South Africa's economy. Between 1912 and 1985, foreign trade accounted for no less than 50 percent of South Africa's GDP. Gold is a dominant export.

Because foreign trade does play such a large role in South Africa's economy, one might plausibly expect South Africa to be vulnerable to international economic pressure. The usual assumption is that foreign direct investment, technology, and capital are linked. If foreign direct investment is cut off, access to technology is cut off as well. Lewis argues that this assumption is not valid for South Africa. He points to the Japanese dominance in South Africa's auto industry, for example, where there is no Japanese direct investment. Japan achieves dominance, and South Africa achieves technology transfer, based solely on product and technology licensing.

World revulsion to apartheid has led to sanctions, disinvestment, and embargoes. And though there is considerable debate over the efficacy of sanctions, disinvestment, and embargoes in achieving their stated goals,

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there is no debate over South Africa's ability to successfully form institutions and strategies for sanctions-busting. In chapters 4 and 5, Lewis discusses how the UN arms embargo led to the rapid development of ARMSCOR. Despite the embargo, producers in France, Germany, Israel, the Netherlands, and Switzerland have continued to carry on trade and licensing agreements with South Africa. Admittedly, the arms embargo meant higher short-run cost for South Africa, but the embargo also led to the development of an arms industry envied by much of the world. In fact, South Africa has become the world's 10th largest arms exporter.

A similar response occurred in the face of the 1973 OPEC oil embargo against South Africa. This embargo costs South Africa an estimated $1 to $2 billion a year, but South Africa has managed to purchase oil clandestinely. In addition, South Africa has developed conservation and exploration programs, and most importantly, she has become the world's leader in the development of coal-to-liquid-fuel conversion plants.

Lewis gives one of the best brief accounts of how South Africa responded to international financial pressures through its introduction of the financial rand. The financial rand insulates South Africa's foreign exchange reserves from the financial effects of disinvestment by establishing conditions under which investors cannot remove foreign exchange from the country unless other investors are bringing in foreign exchange.

South Africa is clearly the economic powerhouse of sub-Saharan Africa. It supplies virtually all of the electricity in Lesotho and Swaziland. It provides contract employment to 350,000 citizens of Zimbabwe, Mozambique, Botswana, Lesotho, and Swaziland. There are another million or so workers from these states employed illegally in South Africa. While South Africa has less than one-third of the region's population, it produces three-quarters of the region's GDP and two-thirds of its exports.

In chapters 6 and 7, Lewis speculates on political change and what a postapartheid South Africa might look like. These are his weakest chapters. He sees a "postapartheid dividend" of $2 billion a year arising from reduced costs associated with the end of sanctions, reduced expenditures on internal security and national defense, and a reduction of white bureaucrats holding jobs by virtue of their race. But Lewis seems to view the existing large state apparatus as a blessing. Lewis writes,

> The new government will inherit a statist economy, marked by high levels of government activity, large parastatal organizations, state regulation of economic activity at a highly detailed level. The levers of control will be in place, ready to be used for a variety of purposes quite different from those for which they were intended by the National Party architects or even earlier governments.

This statement is a dangerously naive assessment of the world history of injustices and the harsh political realities of South Africa.

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History has seen the injustices of Russia's czars replaced with those of Stalin; Chiang Kei-shek's with those of Mao Tse-tung; Bastista's with Castro's; the Shah of Iran's with those of Khomeni; and in most of Africa, the injustices of the colonial powers were replaced with brutal dictatorships and unspeakable human rights abuses accompanied by major economic decline.

Lewis attempts to trivialize some of that history when he says, "The [South African] government has gone to great lengths to paint a dismal picture of the economies of sub-Saharan Africa, particularly those of countries where white minority regimes were succeeded by independent governments." While the South African government's propaganda purposes may be served by exploiting the tragedy of sub-Saharan African states, there can be no denying the fact of self-imposed gross human rights abuses, political graft, mismanagement, and economic decay.

There is little evidence for Lewis' belief that a powerful central government can be an instrument for justice and prosperity. He does not consider that a black government in South Africa could be used to exploit Indians and Coloreds or that a Xhosa government (the Xhosas dominate the upper echelons of the African National Congress) might discriminate against the Zulus or other black ethnic groups. Thus, Lewis offers no precautions against duplication of what exists on the rest of the continent.

There is considerable evidence that the necessary conditions for human rights protections, economic growth, and broad participation in that growth are limited government power, entrenched civil rights guarantees, and strict adherence to the rule of law. It has been precisely the lack of these conditions that explains apartheid. Ignoring those factors is the major blemish on an otherwise worthy book.

Walter E. Williams
George Mason University

Reforming Products Liability
W. Kip Viscusi
Cambridge: Harvard University Press, 1991, 270 pp.

Kip Viscusi is probably the leading safety economist in the world. His writings on safety deserve our close attention. This book, a reworking of previous research with some new material added, is an important contribution to understanding current tort law. Viscusi is so prolific that merely assembling his writings on products liability in one place is a useful contribution. Anyone interested in the "tort crisis" must read this book. This work is not as theoretical as the works of Landes and Posner

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(1987) and Shavell (1987), but it supplies much more evidence and is a good complement to those analyses.

The first chapter sets the stage for the argument. Chapter 2 shows the magnitude of the products liability "crisis" by presenting data on trends and amounts of litigation and on costs of liability insurance. This chapter also includes some evidence on the costs to firms of product liability actions, based on event studies of stock price effects. The next chapter discusses the rational litigation model and shows that it applies to product liability actions.

Viscusi then addresses the "Design Defect Test" and shows that, although this test is now incoherent, it could be reformulated as a negligence test to make some economic sense. Chapter 5 discusses damages, including an analysis of the potential impact of "hedonic" or "deterrence" damages based on willingness-to-pay values. This standard is important in torts liability because some economists advocate use of the willingness-to-pay measure of values, and some courts have adopted it. Viscusi distinguishes between deterrence values and the much smaller compensation values. This difference occurs because consumers would not want to pay (in the price of the product) for the full cost of damage payments equal to the deterrence value in the event of injury or death.

Chapter 6 shows that much product safety regulation is not efficient. Much of this chapter rests on Viscusi's own previous work, such as his studies showing that the Consumer Product Safety Commission has had little positive impact, and that its major measurable impact has been negative.

Hazard warnings, discussed in chapter 7, can be useful if designed correctly. However, most regulatory agencies and most court decisions have led to inefficient design of labels. Viscusi proposes a national policy of standardized warnings. Correct warnings would have the desirable effect of allowing consumers to make risk choices for themselves, although the courts have not so used labeling doctrine.

The next issue addressed is mass toxic tort litigation, as exemplified by the asbestos, Agent Orange, and Dalkon Shield cases. Viscusi concludes that products liability litigation is not a useful solution to the problems caused by hazards of this sort, and that regulation is preferable. However, he shows that regulatory agencies have not done an efficient job with respect to asbestos, but rather have imposed regulations with excessive costs relative to benefits.

Workers compensation is the best functioning system discussed in the book. This system provides incentives for safety, is operated at low cost, and is valued by workers. However, the usefulness of a similar procedure for products liability is limited because manufacturers do not have the same ability to control behavior of consumers as employers have to control workers. Viscusi also examines the interrelationship between work-related products liability (suits by workers harmed by products such as lift trucks on the job) and workmen's compensation.

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The form of law does matter; chapter 10 shows that for the period 1980–84, there was more insurance available in states with laws restricting the scope of products liability, and that insurance is more profitable in such states.

The final chapter summarizes the following reform proposals, which were introduced at other points in the book: use of regulatory agencies rather than tort litigation to determine if products should be manufactured at all, replacement of the current risk-utility test with a negligence standard to determine if additional safety features are justified, improvements in hazard warnings and in doctrine relating to warnings, and use of deterrence (willingness-to-pay) values when the goal of tort liability is deterrence.

While some of these proposals (return to a negligence standard, improvement of warning labels) are sensible, others are puzzling. Viscusi would rely more heavily on regulatory agencies to determine if products should be sold. However, he cites 13 studies of the effects of existing regulation. Of these studies, only one found unambiguously beneficial effects of regulation, and two others found possibly beneficial effects. The other 10 studies found either "no significant" beneficial effects or negative effects. Thus, it is not clear why Viscusi thinks that increased reliance on regulatory efforts would be beneficial, given the record of such efforts to date.

Similarly, Viscusi indicates that using deterrence values for damages would lead to a 10-fold increase in damages, but he advocates such policies in some cases. However, he presents no evidence indicating that juries would be able to determine which cases would be appropriate for such damages. Hence, there is no reason not to expect this policy to simply jack up damage payments with substantial harmful effects. An analogy may be warnings: While well-designed warnings should enable manufacturers to escape liability, the courts have essentially used the warning doctrine to create another possibility for finding liability. Calfee and Rubin (1992) show that excessive damage payments have detrimental effects on resource allocation through price effects.

The major puzzle about the policies Viscusi advocates is this: Products liability litigation occurs in contexts where plaintiffs (consumers) have a pre-accident contractual relationship with defendants (firms). Viscusi himself (1983) has been a leader in showing that much risk is "by choice" in contractual situations. Nowhere in this book is evidence presented indicating that product risks are excessive—that is, that the level of risks in products is greater than the level consumers would desire if they could choose.

Priest (1985) has shown that the switch from contract to tort in products liability was the result of a misconception on the part of academic lawyers, and Viscusi presents no evidence inconsistent with this argument. Therefore, a natural question to ask is, Why not advocate a return to contract in order to control risks associated with products in potential

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contractual settings? Viscusi does not even allude to this reform, but his arguments and data are consistent with such a radical approach.

Paul H. Rubin
Emory University

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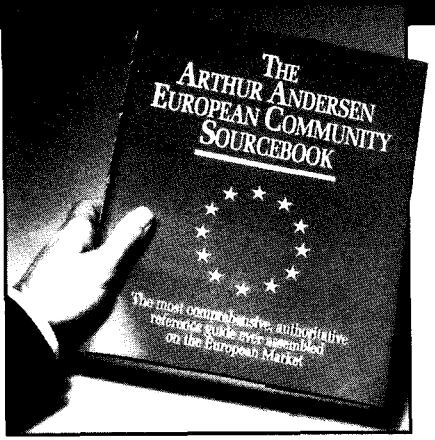
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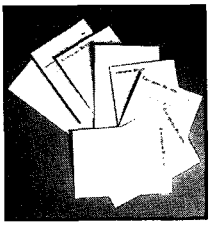

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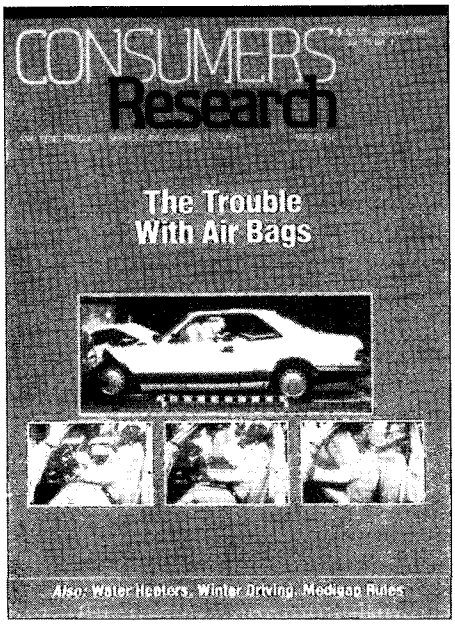

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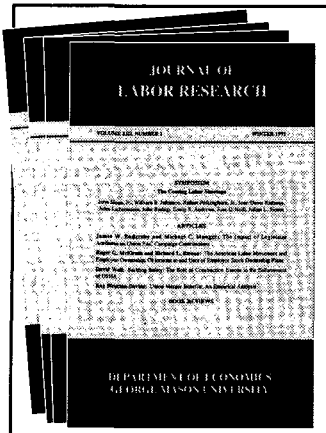

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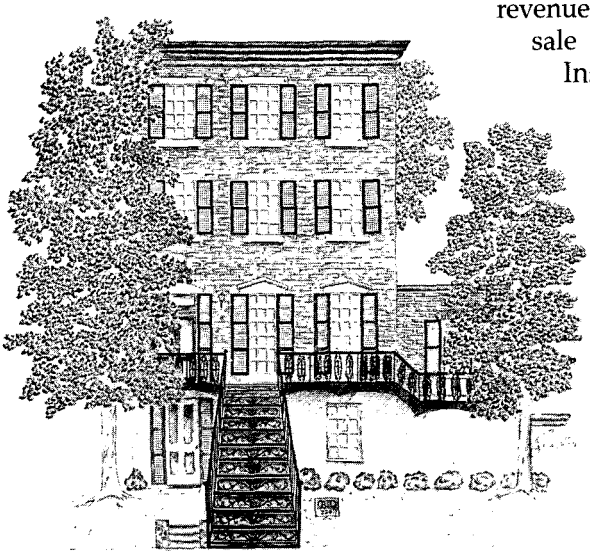
The Institute is named for *Cato's Letters*, libertarian pamphlets that were widely read in the American Colonies in the early 18th century and played a major role in laying the philosophical foundation for the American Revolution.

Despite the achievement of the nation's Founders, today virtually no aspect of life is free from government encroachment. A pervasive intolerance for individual rights is shown by government's arbitrary intrusions into private economic transactions and its disregard for civil liberties.

To counter that trend the Cato Institute undertakes an extensive publications program that addresses the complete spectrum of policy issues. Books, monographs, and shorter studies are commissioned to examine the federal budget, Social Security, regulation, military spending, international trade, and myriad other issues. Major policy conferences are held throughout the year, from which papers are published thrice yearly in the *Cato Journal*.

In order to maintain its independence, the Cato Institute accepts no government funding. Contributions are received from foundations, corporations, and individuals, and other revenue is generated from the sale of publications. The Institute is a nonprofit, tax-exempt, educational foundation under Section 501(c)3 of the Internal Revenue Code.



The Watterston House, headquarters of the Cato Institute

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THE FAILURE OF SOCIALISM

Those of us who have lived under socialism exhibit the once bitten, twice shy syndrome. Perhaps Western socialism is in fact different and will produce different results. But we observe with growing apprehension the ominously familiar personality types, misconceptions, and attempts to institute this system of thought. The truth of the matter is that the various ideas that seem fresh and innovative to Western specialists have already been tested in the USSR. And if some of those experiments were eventually repudiated, it was not because socialism has been perverted in the USSR, as Western commentators claim, but because these innovations proved to be utterly unfit for real life. A cruel experiment half a century long has failed to alter human nature.

—**Vladimir Bukovsky**

To Choose Freedom
(Stanford, Calif.: Hoover Institution Press, 1987), p. 127.

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